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**Financial regulation:
Britain's next European challenge?**

**Sir Brian Unwin and
Graham Bishop**



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**FINANCIAL REGULATION:
BRITAIN'S NEXT EUROPEAN CHALLENGE?**

Sir Brian Unwin and Graham Bishop

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FINANCIAL REGULATION

Britain's next European challenge?

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FINANCIAL REGULATION: Britain's next European challenge?

Introduction

The global financial crisis has many causes, including inappropriate macro-economic policies (notably failure to control public deficits at a time of sustained economic growth,) the greed of individuals and both personal and corporate irresponsibility within the banking and financial system. It is also clear that inadequate supervision and regulation has been a major contributory cause of the crisis and that remedying this inadequacy is a necessary, if not sufficient condition for preventing any recurrence or recrudescence of the crisis. Over the past eighteen months, the European Union has shown itself commendably conscious of the necessity for speedy action in this area, a necessity reinforced in the Union's case by the high degree of interdependence in financial matters which its member states have already achieved. Until now, this interdependence has been reflected only partly in European regulatory structures. The European insurance and reinsurance sectors, for instance, are subject to a high degree of European regulation and their insurance-related activities have been a significant factor for stability during the global financial crisis. The contrast with the recent history of the European banking sector speaks for itself.

On 2nd December 2009, the Council of European Finance Ministers (ECOFIN) concluded a 'political agreement' on the future supervisory structure for the provision of financial services throughout the European Union. This agreement, which is now subject to co-decision with the European Parliament, marks an important building-block in the European Union's response to the global financial crisis which began in 2008. In the months immediately following the collapse of Lehman Brothers, a number of international organizations and national governments called for and set in train a range of measures to make the global economy less vulnerable in future to such seismic disturbances of its financial system; and to regulate more effectively interlocking national financial systems so that similar disturbances were less likely to recur. The European Commission hopes that the process of co-decision with the European

Parliament on the new supervisory structure will be completed by the end of 2010, and that next year will see the adoption of further, sectoral legislation to improve the workings and stability of the European financial system. If this timetable is achieved, the European Union will show itself among global actors as one of the speedier respondents to the financial crisis of the past eighteen months.

In the following report, the authors will review the new supervisory structure for financial services now envisaged for the European Union and consider in general terms the most important issues of governance and policy with which these new supervisory bodies will find themselves confronted. Two specific assumptions underlying the report's analysis should however be stressed at the outset. The first is that, although it is obviously important that any new system adopted in the Union should as far as possible be consistent with reforms introduced elsewhere in the industrialized world, most notably the United States, the European Union is well advised to make what progress it can as quickly as it can in reforming the governance of its financial services. The second is that, given the preponderance of the City of London as a global financial centre and its importance both to the British and the European economies, the United Kingdom has a compelling national interest in participating constructively in this process. These assumptions are sufficiently controversial among some sections of British public and political opinion to merit further discussion.

In some parts of the world, the past year has seen a certain slackening in the impetus towards radical reform of national financial sectors. Operators in the financial sector have been swift to point out that in the past eighteen months the most pessimistic forecasts of economic and financial catastrophe have not been realized. Perhaps the global financial and economic system was not as fundamentally flawed as its traditional and recent critics liked to argue. In the United States in particular, the well-established interests of the financial sector prevented throughout 2009 a new American administration from pursuing as effectively as it might otherwise have done the financial reforms which seemed so pressing in the second half of 2008. In early 2010, President Obama brought forward a major new set of proposals, based on recommendations by the former Chairman of the Federal Reserve, Paul Volcker, for tighter regulation of banks and other financial institutions. A radical new feature of these proposals was the prohibition on deposit-

taking banks from operating hedge funds and private equity funds or trading on their own account. It remains to be seen how successful the President will be in implementing his proposed reforms. The difficulty he has experienced in the passage of his healthcare reforms is not an encouraging precedent. Nevertheless, the direction in which he and his advisers wish to steer American regulatory practice is clear for all to see.

The proposition that reform of the global financial system is today less urgent a priority for national and global action than it seemed even in the recent past cannot in any circumstances however be allowed to pass unchallenged. Many banks and other financial institutions have still fully to recognize in their financial reporting the systematic over-valuation of questionable assets, the partial unwinding of which was at the heart of the first wave of the global financial crisis. National governments moreover are already contemplating the need in the medium term to reduce the budgetary deficits which they have been willing to run in order to sustain economic activity in time of crisis, albeit with only limited success in improving the performance of the real economy. The withdrawal of this financial stimulus, even if carefully and gradually implemented, may well trigger another round of financial and economic upheaval in the medium term. Nor is the solidity of long-term economic recovery assured. There is a real and pressing likelihood that rising capital adequacy requirements, together with the obligation to hold a higher proportion of safe, liquid assets, will make the banking system less able to finance the recovery of the corporate and private sectors. The disappointing figures for bank lending to the British private sector over the past twelve months can only reinforce this concern.

Against this threatening background, reinforced by the now acute fiscal problems of many European governments (most notably Greece and the United Kingdom), the urgency with which the European Union is pursuing its agenda of financial reform seems entirely appropriate and justified. Much greater risks attach in this field to inaction than to proposals for reform pursued with the necessary sense of urgency. Even if the precise events of 2008 and 2009 are unlikely to repeat themselves in 2010, it would bespeak an extraordinary failure to learn the painful lessons of experience if in two or three years time the world's financial system found itself confronted, in an unreformed state, with a recrudescence of the systemic crises which have plagued the global economy over the past eighteen months.

As host, by a wide margin, to the greatest national proportion of the European Union's financial services industry, the British government, of whatever political colour, will have a special interest in the successful conclusion of the European Union's process of reform and reassessment in the financial sector. There is indeed substantial political pressure on the British government, both domestically and internationally, to participate constructively in negotiations with its European and other partners. As the *Financial Times* of 18th December, 2009, remarked "Great Britain is not a financial island." The global financial crisis of 2008 was a stark reminder of the interconnectedness of global financial services. This interconnectedness is a particularly prominent feature of the European internal market, pursued as a conscious political goal for many years. It is of course for the British government and other leading decision-makers in the United Kingdom to decide what proportion of their national economic activity they wish to devote to the specialized area of financial services. Even within the United Kingdom, there is a growing body of opinion which believes that the British economy has relied too much over the past decade upon financial services, with the manufacturing sector now representing not much more than 10% of national output, and that this imbalance has created a particular British vulnerability that will need to be corrected in coming years. The United Kingdom's ability to continue to market such services on a European and global basis will depend at least in part upon Britain and the City of London's ability to present themselves as 'good global citizens', recognizing that the free movement of financial services within the European Union in particular brings with it obligations as well as commercial opportunities. It can only harm the global reputation of the City of London if the British government as its champion refuses to regard as in any way legitimate the concerns of its partners, particularly in Europe and America, about the potential implications for their own financial systems of the way in which major providers of financial services, such as the City of London, go about their business. It was after all the London - based activities of AIG which played a major part in precipitating the near-fatal liquidity crisis of the American parent in 2008.

Nor, as the Irish and Icelandic cases show, can British savers and investors be isolated from the effects of national failures of supervision among their neighbours. British public and political opinion has little difficulty in accepting the role of the European Union, and in particular

that of the European Commission, in guaranteeing free competition within the financial sector. The role of Mrs. Kroes, the Commissioner responsible for competition policy, has been central over the past five years to the restructuring of much of the European banking industry and her activities have won widespread plaudits within the United Kingdom. Some commentators indeed have seen her role as being that of filling the regulatory gap left by patchy European supervision of the financial sector. The arguments in favour of a robust European competition policy in the financial sector and those in favour of a greater European component to the supervision of this sector are very closely related. It makes no more sense for there to be unconnected national regulatory regimes for financial services within the Union than it does for there to be unconnected regimes for the prevention of anti-competitive practices or structures.

Even if it wished to do so, the British government would not be able to terminate through its own decisions the process of review which is now under way in the European financial sector. Most of the measures envisaged are to be adopted by qualified majority voting in the Council of Ministers. It is widely believed in the European Union that the allegedly lightly-regulated City of London was an important transmission mechanism for the transference to continental Europe of the American financial and economic crisis. The voting of national ministers in the Council of Ministers on European financial regulatory supervision has reflected and will continue to reflect this view. The United Kingdom would have few allies for the argument that the functioning of the City of London cannot in any circumstances be a matter of concern to Britain's European neighbours. As a large member of the European Union, with a particular interest in the provision of financial services, the United Kingdom should be well placed to shape and influence the specific decisions taken by the Union on financial matters. It would greatly reduce this capacity for influence if it appeared systematically to be denying the legitimacy of the whole European financial regulatory process. As so often within the European Union, a British government working with and understanding the concerns of its European partners is much more likely to be successful in advancing specifically British interests than one seeking confrontation. The first public utterances of the new European Commissioner responsible for financial services, M. Barnier, strongly suggest that he is willing and eager to work constructively with the British government and in an independent manner, despite the initial provocative remarks

accompanying his appointment from M. Sarkozy and sections of the British press. Like any European Commissioner, M. Barnier will need to work hard to build the greatest possible degree of consensus within the Union for his proposals. Fears of a European regulatory system for financial services dictated by Brussels and Paris are well wide of the mark.

The de Larosière proposals

It is important to understand that the financial reforms currently under discussion within the European Union should be considered under two distinct headings, namely that of the present proposals for general institutional change; and then that of the likely role these new institutions may play after their inception in the Union's future approach to specific financial sectors or specific aspects of financial regulation and supervision. The proposals for institutional reform derive in essence from the work of the de Larosière committee, the conclusions of which, published in March, 2009, have been widely welcomed, not least by the European Council of June, 2009. Even before the crisis, the European Union was engaged on a major programme of detailed financial reform to complete the internal market in financial services (the Financial Services Action Plan.) Many of the proposals brought forward under this programme have now acquired new relevance in the light of changed circumstances or have needed revision. The new institutions which the European Union is now setting up will undoubtedly play a central role in the discussion of these detailed proposals. But while the de Larosière proposals form in themselves a coherent whole, which essentially can only be accepted or rejected in their entirety, more narrowly-focussed European sectoral legislation usually can and should be viewed on a case by case basis.

In the United Kingdom, this distinction has sometimes been blurred. Those seeking to argue against individual items of proposed legislation have criticized the general institutional model proposed by de Larosière, while those hostile to the latter's new institutional architecture seek to disparage it by referring to the supposed defects of individual legislative proposals under consideration in the Council. But Mr. de Larosière is not the begetter of such controversial proposals as the proposed Alternative Investment Fund Managers Directive; and the Directive's faults or merits are only very tangentially related to the argument about new financial institutions for the European Union. The discussion will gain in clarity and transparency if the two areas of discourse are kept separate.

Since their first publication, the proposals of Mr. de Larosière for institutional reform of Europe's financial system have won a growing number of supporters throughout the European Union. The Commission endorsed them in its Communication to the Council of 27th May, 2009. The European Council of October, 2009, repeated its endorsement at the

previous European Council in June, 2009 of the de Larosière report as 'the basis' of discussion and decision-making. It should not be supposed that this widespread welcome for the de Larosière proposals could be taken for granted. Mr. de Larosière knew that a range of national interests and prejudices needed attention if his proposals were to be widely acceptable. In both his proposals and his later advocacy of them, Mr. de Larosière has shown all the caution and realism which characterized his period of office in the IMF. Far from being a recipe for unrestrained centralization, his blueprint is one which is noticeably respectful of national procedures and national decision-making. Of the two main new institutions suggested by Mr. de Larosière, one, the European Systemic Risks Board, (ESRB) is a consultative and not an executive body. The other, the European System of Financial Supervisors (ESFS), will act primarily as co-ordinator, overseer and advisor to national regulatory bodies. Its autonomous and discretionary powers will be largely confined to the resolution, if necessary by its own binding decision, of disputes between national financial regulators.

The ESRB indeed has attracted criticism for its insufficiently robust mandate, not least from Members of the European Parliament, fearing that it may lack sufficient formal powers for its allocated tasks. Composed of heads of Central Banks, the Board's task will be to analyze on a continuing basis practices and policies within national financial sectors that in their aggregation can lead to systemic risk for the Union as a whole, without these dangers necessarily being apparent to individual national regulators. When it has discerned such a risk, the Board will warn those involved of the risks they are running, both for themselves and their neighbours. This warning will first be issued in private and then publicly. Although the Board has no powers of direct enforcement, all the Member States will be represented on the Board and might be expected to wish to implement its findings. The authority of the Board's members would lend unusual moral weight to their recommendations and financial markets may be expected to take notice of their published analyses. The philosophy which underpins the Board, that the integration of the European Union's economies and financial services can bring risk as well as benefit to all participants, is one which the events of the global financial crisis have reinforced in the minds and attitudes of Europe's financial elites. They are in consequence likely to be a receptive audience for the Board's attempts at moral suasion.

Much of the work carried out by the other body proposed by Mr. de Larosière, the European System of Financial Supervisors, will also be based on moral suasion. Indeed, in normal times its only direct responsibility will be for the regulation of credit rating agencies, a sector particularly appropriate for supranational regulation. The new body essentially represents an upgrading, with more staff, responsibilities and resources, of the existing European Committees responsible for the co-ordination of European regulatory activities in the sphere of pensions, insurance and stock markets. These Committees will be replaced by a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA), which will all have legal personality. Mr. de Larosière has been at pains to stress that his proposed reforms will not deprive present national regulators of financial services of their existing remit and responsibilities. The System of Financial Supervisors will be charged with promoting agreement between national regulators on common technical standards and on common guiding principles (the 'common rule-book') for differing financial sectors, but providing they observe these common European standards and principles, it will be for individual Member States to decide the precise regulatory structure they wish to give themselves, for instance by directly involving the national Central Bank in financial regulation, as the German government has recently decided to do and the Conservative Party has said that it will do if elected in this year's British General Election. National regulators will, however, be obliged to participate in a process of enhanced information-sharing and common analysis. If this process leads to the conclusion that one national regulator is pursuing policies inimical to the stability and integrity of the internal market, it will be for the Financial Supervisors to mediate, and if consensual mediation fails, they will have the right to impose a solution, an event known as 'binding mediation'. In these circumstances, the decision of the Supervisors will prevail against national protests, unless the aggrieved member state can persuade a majority of other member states to overturn in the Council the decision of the Supervisors.

Unsurprisingly, this last aspect of the de Larosière package, arguably the only genuine element of centralizing constraint in the proposals, has been controversial for some governments, notably the British. While the underlying principle of 'binding mediation', particularly in times of crisis or emergency, has been generally accepted, fears were expressed at the

European Council of June that the procedure could, in some circumstances, have a substantial adverse fiscal impact on individual Member States, for instance if the national budget were forced to give financial support to an institution which had fallen foul of the mediation process of Financial Supervisors. This possibility was both philosophically and practically uncongenial to a number of Member States. Assurances were given at the time of the Council in June, 2009, that the decisions of the Financial Supervisors would not impinge upon the fiscal sovereignty of the Member States, and the possibility of a right of appeal to ECOFIN and to the European Council against decisions which might appear to do so was held out in prospect as a further component of the new system. The 'political agreement' adopted by ECOFIN on 2nd December, 2009, indeed envisages precisely such a constraint upon the decision-making of the Financial Supervisors. Individual governments will have the option of appealing to ECOFIN and the European Council. A simple majority within ECOFIN will suffice to overturn a decision of the Supervisors. In normal times, this system will no doubt function effectively to help and reassure governments discontented with an adverse decision. Whether at a time of crisis it will ever be possible, politically or practically, to construct such a majority against the Supervisors, is much more difficult to predict.

The dilution in this fashion of the main discretionary decision-making power given to the Financial Supervisors by Mr. de Larosière's proposals is an indication of how far the European Union currently finds itself from the caricature sometimes drawn by its critics of a power-hungry centralizing bureaucracy, intent on drawing all decision-making to itself. The European Parliament indeed, in its forthcoming consideration of the relevant legislative texts, may well argue that the Council wants unacceptably to limit the power of the Board and of the Financial Supervisors. The first reactions of Members likely to play a leading role in the European Parliamentary discussion have been almost unanimous in expressing this unease. All four Parliamentary rapporteurs leading the examination of the proposals have for instance questioned the safeguard clause protecting the fiscal powers of member states. Like all structures of governance with substantial federal features, the European Union is constantly wrestling with the question of the appropriate distribution of competences between the centre and the component parts of the Union. The final institutional structure for the European Union's financial sector will inevitably need to strike a balance between the necessary degree of

central co-ordination of regulation (an essential feature for the system's stability) and the traditional respect accorded within the Single Market framework to the role of each member state.

The supervisory and regulatory structures proposed by Mr. de Larosière can reasonably be regarded as an extension to the financial sector of the general philosophy of the European Union's internal market, namely that national regulators should normally be responsible for the implementation of European standards, and should only be over-ruled when they fail to implement these agreed European standards. Viewed from one perspective, these structures are centralizing in character. Viewed from another, they are highly decentralizing. If this is a paradox, it is one central to the way the European Union has always worked and is likely to continue to work. The leading role of national regulators and the reinforcement of European co-ordination are not alternatives, but complementary elements of the European Union's emerging regulatory and supervisory structure for financial services.

The future of the de Larosière proposals

The proposals of the de Larosière report were given legal form by the European Commission on 25th September, 2009, which has sent a legislative text implementing the new financial institutional architecture to the European Parliament and the Council of Ministers. It is this text which has overwhelmingly formed the basis of the 'political agreement' adopted by ECOFIN on 2nd December, 2009. Legally, the Council will be unable to take any final decision until the Parliament has formed its opinion, a matter which is likely to take a number of months for such an important and complex issue. The current timetable of the Parliament does not envisage a plenary debate on the issue before September, 2010. It is by no means certain that once the European Parliament has produced its first reaction to the Commission's text that the matter can be quickly resolved thereafter. Agreement within the Council and between the Parliament and the Council are discrete stages of the legislative process that may well take weeks or even months to be completed. If, as seems likely, the European Parliament calls for changes in the terms of the ECOFIN 'political agreement', probably to enhance the autonomous powers of the new central institutions, further negotiations between the Parliament and the Council will be unavoidable. It would be surprising if final decisions can be taken much before the end of 2010.

One consequence of this likely timetable is that a decision to adopt or reject the de Larosière proposals may well be one of the first European decisions taken by the new British government elected in the forthcoming General Election. Piquancy is added to that prospect by the fact that on these matters the Council will decide by qualified majority and not by unanimity. A negative vote in the Council of any incoming government would probably not be enough to block the setting up of the European Systemic Risk Board and the European System of Financial Supervisors. Nor is it likely that a continuing Labour government would wish to vote in this way. For a newly Conservative government however, it would be a symbolically and practically important indication of Conservative European policies in government whether Mr. Cameron and his colleagues were prepared to join what seems likely to be the overwhelming majority of the Council of Ministers in voting for the implementation of the institutional structure proposed by Mr. de Larosière.

The next British government and European financial regulation

There is a view current among certain commentators that, whatever its outcome, the next General Election will change relatively little in the United Kingdom's European policies. On this analysis, the apparent willingness of the present Labour government to accept something like the institutional changes proposed by Mr. de Larosière would be mimicked, perhaps after some initial public doubts, by any Conservative government elected in the course of 2010. This prediction may of course be correct. The shadow Conservative Chancellor of the Exchequer, Mr. Osborne, has for instance said that he would be willing to 'trade' in order to protect Britain's financial services industry. But there are also reasons to be sceptical about the willingness of a newly elected Conservative government to be seen in the first weeks of its administration to be voting for a real, if limited increase in sovereignty-pooling, particularly in such a politically sensitive domain as the regulation of the City of London. There are powerful voices among the Conservative Party's backers warning the Party that any Europeanization of financial regulation should be regarded with the utmost suspicion. Mr. Cameron might be under considerable pressure from his party to turn the question of financial regulation into an initial trial of strength with his European partners. In other circumstances, an incoming Conservative government might have hoped for help and understanding for the resolution of this dilemma from other generally like-minded European heads of government such as Mr. Sarkozy and Mrs. Merkel. Mr. Cameron's relations with these two well-established European leaders, however, have been compromised by his decision, against their advice, to withdraw the Conservative Members of the European Parliament from the centre-right European People's Party parliamentary fraction.

If Mr. Cameron did decide to please his party, already uneasy at his refusal to hold a referendum on the now-ratified Lisbon Treaty, by refusing to endorse the institutional proposals of Mr. de Larosière, the consequences could be dramatic. The political momentum behind the proposals is such that the great majority of Member States favourable to institutional reform would almost certainly be prepared to vote down the United Kingdom in the Council on this issue. Nor can it be excluded that France and Germany in particular, whose co-ordination of policy on these matters was reaffirmed at the recent France-German Summit, might

be willing to use the Lisbon Treaty's provisions for 'enhanced co-operation' in order to set up the desired new institutional structure. This would be both a destabilizing setback for the Conservative Party at the beginning of its period in office, and damaging to the position of the City of London, where substantial continental European representation has come over recent years to be a constituent feature of the City's functioning. It is difficult to believe that British self-isolation from central European financial regulatory bodies would be compatible in the long term with a continuing major European presence in the City. Such considerations will undoubtedly have weighed with the present British government in its discussions on financial services with its European partners over the past year. Despite its apparent initial doubts about certain aspects of the de Larosière proposals, the British government of Mr. Brown and Mr. Darling concluded that British interests were better served by the United Kingdom's remaining within the mainstream of European discussion of these issues. If they are elected to government in the British General Election of this year, it will be an important decision for Mr. Cameron and Mr. Osborne whether they wish to do the same. Conservative spokesmen have recently claimed that they would be willing to move swiftly in government towards the establishment in the United Kingdom of a regime of "more intrusive regulation" for the financial sector. (See the Financial Times of 12th February 2010.) Such willingness to countenance domestic 'intrusiveness' might make it logically more difficult for the party to reject European 'intrusiveness' as a matter of high principle.

Possible implications of European financial regulation

The setting up of a new institutional architecture for financial services in the European Union is attractive to the member states of the European Union not merely as a recognition that a functioning internal market in financial services entails much more in the way of shared decision-making than has been the case until now. The new institutions are also rightly seen by their advocates and founders as an opportunity to learn the regulatory lessons arising from the financial and economic crisis of the past two years and apply them to the questions of financial regulation which the European Union is now considering. These lessons are likely to be not merely technical and sectoral. The new system of European financial regulation can be expected to reflect a more sophisticated understanding of the relationship between the provision of financial services and the wider economy. To say the least, those active in the financial sector are not always the best judges of how this relationship should best be structured. Certain of the sector's spokesmen have, over the past eighteen months, given little indication that they understand the widespread public hostility towards them which the unfolding of the global financial crisis has generated. There is not infrequently a tension between the interests of shareholders and salary-maximising financial operators on the one hand and the need of the non-financial sector of the national economy for robust and reliable financial services to facilitate its objectively welfare-enhancing activities. On occasions, national governments have lost sight of this reality. The existence of institutions operating at the European level will make it less likely that the specific circumstances of individual member states can lead national governments to take or acquiesce in decisions favourable only to powerful economic or social sectors of their own national economies. Such decisions are not always even appropriate to the overall national interests of individual member states. Financial regulation is another example of the apparent paradox whereby national governments can sometimes enhance their national sovereignty by pooling it.

Although the global financial crisis which began in 2008 should not be, and is unlikely to be used as a pretext to justify any and every proposed tightening of European financial regulation, the new European supervisory institutions will undoubtedly bear firmly in mind the one undeniable lesson of the crisis, that within the globalized capitalist system

financial markets can easily fall prey to a wide spectrum of destructive (and often self-destructive) tendencies within their likely patterns of behaviour. The supposedly self-righting mechanisms of the financial markets, which were particularly cited in the United Kingdom as justification for the policy of 'hands off' regulation, have shown themselves much weaker in the past decade than many commentators and politicians expected. Banks which are 'too big to fail' were a foreseeable outcome of the supposedly competitive financial markets which have been so prominent a feature of the global economy in the last ten years. The very existence of such banks represents a major error of policy and is a manifest demonstration of the failure of the traditional financial system to correct its own disequilibria by the self-healing process of which its most enthusiastic advocates insisted it was capable. The personal and corporate incentives underpinning the global financial system in recent times, particularly but by no means exclusively in the United States and the United Kingdom, are now shown only imperfectly to have corresponded to the undoubted public interest in the existence of an efficient and innovative financial sector, with a cautious approach to risk management. European financial regulators are rightly likely to be more sceptical in future of claims by the lobbyists for the financial sector that all is for the best in the best of all possible worlds, provided only that financial intermediaries are allowed to pursue their activities undisturbed by governments. In their approach to such questions as banking structures, remuneration, rating agencies and alternative investments, European regulators will not take for granted the disinterested reliability of those denying that regulators have any constructive role to play in the management of these issues. Recent utterances from the American administration make it clear that these European attitudes will find a definite echo on the other side of the Atlantic. The fear that any European move towards more interventionism in financial markets may render the European financial industry less competitive or vulnerable to arbitrage, and at the same time create a damaging split with our American partners, seems an increasingly implausible one. If anything, the recent proposals of President Obama go noticeably beyond reforms currently proposed or contemplated in the European context.

Banking Structures

It will be a central function of the new European Systemic Risk Board to monitor developments in one or a group of member states that might cause risks for the European financial system as a whole. Given the functioning of the world's financial systems since 2008, it is difficult to imagine that the activities and structures of major European banks will not lie at the heart of the Board's monitoring activities. Two related questions in particular are likely to attract the attention of the Board, the amount and nature of the credit extended by the banks in question; and the extent to which banks are independently active in financial markets. Both these questions are in their turn linked with the fundamental issue already mentioned, that of the existence of financial institutions which can plausibly be regarded as 'too big to fail'. On both sides of the Atlantic, this latter conundrum is widely recognised as an intolerable circumstance in the supposedly free market for global financial services.

Within the European Union, it is clear that different social attitudes exist to credit-related questions. The wide disparity in the use of credit cards and in the recourse to mortgage finance within the European Union both reflect and perpetuate these differences. It should not of course be the role of the Systemic Risk Board or the European Financial Supervisors to ensure that precisely similar levels of mortgage and other credit arrangements are prevalent throughout the European Union. It will on the other hand be a legitimate exercise of their responsibilities to draw attention to levels of lending within national economies which are themselves potentially unsustainable, and in particular to the consequences which these levels may have for individual financial institutions. Such risks are probably not imminent today, but cannot be discounted for the medium term. National regulators may well be excessively willing to believe the reassurances they receive from their national financial operators that high and increasing levels of lending simply reflect the efficiency of credit markets and innovative approaches to the extension of credit by prudent lenders. Their European peers may be more sceptical about such potentially self-serving arguments. National regulators will find themselves reminded by these European peers of the risks which may arise from the ballooning of credit levels, unrelated to developments in the real economy, a problem which has beset the Spanish and British economies in particular for much of the last decade. It will be for national regulators to decide how they ensure that the

willingness of lenders within their jurisdiction to extend credit to personal and corporate borrowers is of a scale and nature not to create systemic risks. The pressure upon them to do so, emanating from the Board, can however only be a positive outcome from the new institutional architecture of the Union's financial regulation.

Similar considerations will naturally apply to trading by banks on their own account in financial markets. Both corporately and individually, there have been great incentives for banks to increase their size, profitability and salaries by trading in financial markets, not on behalf of clients, but on behalf of the institutions themselves. Once again, it will be for national regulators to decide how best to check the obvious possible problems arising from a confusion of the roles of deposit-taking institutions and that of financial speculators. Some overlap of the roles is perhaps inevitable, when banks act directly on behalf of their clients. But this overlap cannot be a justification for entirely setting aside the risks, to the institutions involved, to the national economy and to tax-payers from a financial gigantism which is rational for the direct participants, but irrational from the point of view of the common interest. The drawing of a clearer line between investment ('casino') banking and retail banking is at the heart of President Obama's recent regulatory proposals for the American financial sector. Some European banks, such as ING, have already announced proposals to separate these two areas of banking activity. In the United Kingdom, opinion seems divided, with Lord Mandelson arguing in a recent speech (New York, 4th March 2010) against separation, while both the Governor of the Bank of England (particularly in his speech of 25th February 2010) and the Shadow Chancellor of the Exchequer have indicated their sympathy for such an approach. The higher levels of capital for trading activities by banks that now seem likely to be mandated by international agreements via the G20 also point in the same direction. Whether this will take place by direct national legislation to draw a clear distinction between 'narrow' and 'investment' banking, or by moral and fiscal suasion, can only be a matter of speculation. But it is a highly likely outcome that the European consumer, in the United Kingdom and elsewhere, will be a beneficiary of this greater clarity.

Remuneration

Until recently, it was widely believed in financial circles that the immensely high salaries and bonuses paid to leading bankers, particularly leading investment bankers, were an economically rational response to the need for their employers to attract the most talented staff to generate high profits for their institutions. Much doubt, however, has been cast upon this analysis by the unfolding of the global financial crisis over the past eighteen months. Both the Turner Report of 2009 and the de Larosière Report itself have argued that remuneration and incentive schemes within financial institutions have over-rewarded staff for short-term outcomes that have proved destructive of long-term profitability for their employers. The volume of the revenue accruing to financial institutions that has been devoted to bonuses has, moreover, acted as a substantial constraint upon the ability of these institutions to devote resources to investment productive in the long term. Far from being an instrument of economic rationality, high salaries, and more particularly the culture of bonuses related to short-term financial results, have created a distorted calculus of risk and reward for decision-makers in the financial sector, while bringing bankers and their profession into general disrepute with their fellow-citizens. The Bank of England's Executive Director for Financial Stability, Andy Haldane, recently remarked in this connection: "If UK banks had reduced dividend payout ratios by a third between 2000 and 2007, £20bn of extra capital would have been generated. Had payouts to staff been trimmed by 10%, a further £50bn in capital would have been saved. And if banks had been restricted from paying dividends in the event of an annual loss, £15bn would have been added to the pot. In other words, three modest changes in payout behaviour would have generated more capital than was supplied by the UK government during the crisis." (Speech, 27th January, 2010)

The Bank of England's Financial Stability Report of 2007 noted that the availability of cheap money, a phenomenon particularly helpful to large banks, had increased the assets of the sixteen largest complex financial institutions in the world from over \$10 trillion in 2001 to over \$22 trillion in 2006. No corresponding rise in investment in the real economy could however be discerned over that period. Over the five years in question, asset inflation was driven primarily by the creation of financial products and their trading between financial institutions, a process in the perpetuation of which highly-remunerated financial intermediaries had a

clear and pressing personal interest. The financial crisis of the past eighteen months has at most somewhat diluted and certainly not restructured this perverse system of incentives. No aspect of the global financial crisis has attracted more public resentment than the continuing payment of large bonuses, often representing a substantial proportion of turnover and profit, to their leading employees by financial institutions, especially those which have benefitted from direct public funding. Because of their continuing concerns about the stability of the global financial system and about the sustainability of the present modest emergence from global economic recession, central banks and government treasuries are still today injecting cheap capital into the private banking system, thereby favouring the conditions for large profits and consequent large salaries in the banking sector over the coming years. It is not easy to conceive of a conjunction of circumstances further removed from the paradigm of the free and unfettered marketplace which supposedly generated the generous compensation packages of the best-remunerated actors in the financial sector.

Once again, the primary responsibility for counteracting this systemic anomaly, whereby high salaries are intimately linked to potentially destabilizing activities by financial actors, will lie with national regulators in Europe. Their common action, which there is every reason now to believe can be co-ordinated with that of American regulators, will create a powerful exemplary effect. The current situation is being examined in detail by the Financial Stability Board to check compliance with their remuneration guidelines. Their questionnaire will be completed soon and the first results should be considered by the G20 at their June meeting in Toronto. A number of policy responses have already been canvassed, going well beyond the until now largely ineffectual 50% tax imposed by the British government on banking bonuses, which has led to the highly publicized self-denial of their personal bonuses by the CEOs of most large British banks, but seems to have had little impact on the general bonus culture. Possible policy responses include a tax on the trade in structured products along the lines of the Tobin tax with the aim of discouraging economic activity that can be shown to have no or negative social utility; a change in corporate taxation rules so that staff compensation can no longer be claimed as a cost to be deducted prior to taxation, with the result that capital and liquidity should be built up within financial entities and not expended on over-large compensation packages; and implementation of a 'narrow banking' policy, whereby regulation should

be focused on the objectives of consumer protection and protecting the integrity of the payment system of retail banks. Any of these proposals would five years ago have had very little chance of being taken seriously by even a minority of the member states of the European Union. The realization, however, that excessive levels of remuneration in the financial sector represent a malformation of the competitive market economy rather than an expression of its efficient working, have brought all these suggestions much nearer to the mainstream of European regulatory thinking. The new supervisory institutions of the European Union are very likely to encourage the installation of some at least of these changes over the coming years. Those who in the short term find themselves the losers from such developments will understandably resent the European contribution to their changing circumstances, but will have to recognise that this is being co-ordinated as a global policy response by the G20. Their complaints should not necessarily be regarded as a legitimate expression of thwarted national interest.

Alternative Investments and Derivatives

A pending item of European legislation on which the new European financial institutions may well wish to express an opinion is the Alternative Investment Fund Managers Directive, proposed by the Commission in April 2008 and currently under consideration in the European Parliament and the Council. An unexpected coalition of interests, including the Church of England, the House of Lords and the European Central Bank, expressed concern about the original text of the Directive. Among other provisions, this Directive in its original draft sought to increase the capital requirements for hedge funds and similar investment vehicles; to restrict fund leverage; and to create an obligation for the funds to deposit their cash and other assets at an EU credit institution. Critics have argued that these changes would substantially raise regulatory and compliance costs, for only minimal benefit to consumers and little impact on the stability of the European financial system overall.

In some of the criticism deployed against the Directive there has been more than a whiff of special pleading. It can certainly be argued that hedge funds and similar alternative investment vehicles made no direct contribution to the banking crisis of the United States and Europe last year. But that does not mean that hedge funds could never contribute to systemic uncertainty, whether directly or indirectly. Recent experiences within the Eurozone are very much a case in point. It does not seem unreasonable to expect greater transparency on the part of the institutions engaging in such activities. The proposed obligation for them to use European banks, or, as the new text of the proposed Directive allows, banks later recognized as having the same degree of reliability as European banks, is entirely of a piece with this philosophy. Whether the precise degree of restrictions on leverage and the prescriptions on capital adequacy are appropriately framed is a separate issue. Some British commentary on this question has been notably, even counter-productively shrill, but Commission spokesmen have strongly hinted that they regard the draft Directive as a basis for negotiation rather than a finished product. Discussion continues, and it is possible that final decisions will fall to the next British government. If it is a Conservative government, similar dilemmas may well face Conservative policy-makers to those already discussed in the context of the overall institutional architecture now proposed for the regulation of European financial services.

A further issue on which the new regulatory bodies will need to express an opinion is that of the specialized field of derivatives transactions, to which the Commission is now turning its attention. Many non-financial institutions need derivative transactions to help them hedge against, for example, a future increase in the price of a raw material vital for their business. There is no case for the Commission's making such transactions unnecessarily difficult or expensive. On the other hand, some aspects of derivatives trading have undoubtedly played a part in exacerbating the global financial crisis. It will be for the Commission, in consultation with the new regulatory institutions, to strike the proper balance between these competing considerations.

Following the G20 lead, the Commission is now moving in the direction of forcing as much derivatives activity onto regulated exchanges and centralized clearing mechanisms as possible in order to increase the transparency of this trading activity and to manage more effectively the risks when unexpected problems emerge. The Commission and the new supervisory institutions will need to work closely together to ensure that the centralized clearing mechanisms being proposed operate in such a way that they do not become sources of unacceptable systemic risk themselves. The Commission envisages that highly specialized transactions not suitable for standardized exchanges and clearing mechanisms will still be permitted, but it is likely that any financial institution involved in such transactions will be compelled to set aside more capital reserves. This requirement will undoubtedly increase the cost of the relevant transactions, but is defensible if it represents a more appropriate price for underlying risk. As a general principle, care must be taken in ensuring that 'socially useful' derivatives activity is not rendered prohibitively expensive. There is no reason to suppose the European Union will be incapable of striking the proper balance in this area.

Conclusion

Although it is always difficult to predict the precise outcome of European negotiations on institutional questions and even more difficult to predict the precise functioning of these new institutions once created, a clear outline is already emerging of the likely institutional structure for the future regulation of financial services in the European Union and some reasonable speculation is already possible about the workings of these institutions. In important respects, these new institutions and their likely functioning will mark a noticeable change for those active in the financial sector. While their primary interlocutors will continue to be national regulators, these regulators will not be operating in a European vacuum; national decisions and practices will be subject to peer review and in some occasional instances to being over-ruled by European bodies. The European consensus represented by these latter bodies will not necessarily be identical with the varying national attitudes which have held sway until now.

Among the member states which traditionally have found unwelcome the implementation of major changes as a result of European initiatives the United Kingdom is perhaps the most conspicuous. The strength and depth of its financial sector ensure that these questions are of particular political and economic sensitivity in the United Kingdom. There are many British commentators and politicians predisposed to believe that European regulation in the financial sector will normally be harmful to the City of London. British governments in recent years have been inclined to take seriously, often on the basis of little evidence, the possibility of a substantial relocation of financial services away from the City to France, Switzerland or even China. As a major source of taxable income for an indebted British government, the City is an effective lobbyist for what it sees as its own corporate interests and those who work in it. A Conservative government in particular might find it difficult to emancipate itself, even if it wished to do so, from the influence of City opinion arguing with apparent persuasiveness that the extensive British financial sector has nothing to learn from its considerably smaller continental neighbours, much less any reason to go further in sharing regulatory decision-making with them.

But the history of British participation thus far in the negotiations on European financial regulation is illuminating. Despite its clear

reservations on the issue, the New Labour government has concluded that it had no real choice but to participate as constructively as it felt able in these negotiations. While ministers have trodden a careful rhetorical path, being eager to reassure City opinion about the limited nature of the proposed reforms, by no means all their utterances have been hostile to the principle of greater scope for European decision-making in the financial sector. Even more intriguingly, the Shadow Chancellor of the Exchequer, George Osborne, has recognized that financial regulatory questions might well be questions on which, in government, he and other Conservative ministers might wish to 'trade' with their European colleagues, given the central role of the City in the British economy. Mr. Darling and Mr. Osborne have no doubt been influenced in their approach by pragmatic considerations. It could hardly be in the long-term interests of the City of London for the United Kingdom to exclude itself from a European regulatory regime which the overwhelming majority of its partners are clearly set upon creating. But there is another set of considerations which should also weigh with any British government in its approach to European financial regulatory issues. These considerations derive from the likely decisions of the new European institutions and the regulatory philosophy which will guide them.

One reason (and not the least important) why British popular hostility to the European Union has grown over the period of the New Labour government since 1997, is the unrelenting insistence of British ministers during that period that the way in which the British economy was managed was in almost every respect superior to the way in which continental European economies were run. Arrogant and caricatural contrasts were drawn between the plodding inadequacy of the supposedly highly-regulated continental European economies and the dynamic, flexible and forward-looking British economic model, with the success of the City of London standardly cited as a central instance of the validity of this contrast. The events of the past eighteen months, however, have cast considerable doubt upon every element of this analysis. There are many fewer commentators in the United Kingdom than there were who believe that the British economic future is unambiguously brighter than that of, say, Germany. The economic statistics of the past eighteen months would give no support to any such expectation. There are many fewer commentators than there were who believe in the exemplary efficiency of the City of London, or believe that its workings are incapable of improvement. Indeed, the ways in which the City is now seen as lacking

by many Britons are precisely the faults which its critics, in this country and elsewhere in Europe, traditionally thought they detected in it, such as an obsession with short-term financial manoeuvres; personal enrichment through operations of dubious social value; and the pursuit of ever-more complicated financial products as an end in themselves rather than a concomitant to genuinely productive economic activity.

If the new European regulatory and supervisory system can act as a counter-balance to the excessive development of such tendencies, then it will be acting in a way that should command the enthusiastic assent not merely of Mr. Sarkozy and Mrs. Merkel, but of many British citizens and commentators as well. There is good reason to believe that financial regulation with an increased European component can be better than exclusively national financial regulation, taking more account of the spectrum of legitimate interests involved. It would be a strange and paradoxical outcome if a narrow understanding of the national interest led the United Kingdom's government to turn its back on the new possibilities being offered to it. In the short term, the British government, of whatever political complexion, needs to finance a record fiscal deficit. In the medium term, it needs to produce a convincing programme for reducing that deficit. Neither of these outcomes can be guaranteed. Their achievement will certainly however be facilitated if the British government is acting, and is seen to act, within a credible framework of financial regulation. This framework is unlikely to be attainable without a substantial European component to its construction.

A review of the workings of the new European supervisory institutions is currently planned for a date three years after they take up their functions. It is to be hoped, and it is by no means impossible, that by that time the British government will have learned to stop worrying and learned to love European financial regulatory structures instead.

APPENDIX

EUROPEAN FINANCIAL REGULATION: THE PROPOSED INSTITUTIONS

The European Systemic Risk Council (ESRC) will monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole (“macro-prudential supervision.”) The creation of the ESRC is designed to limit the vulnerability of the European financial system to interconnected, sectoral and cross-sectoral systemic risks.

The members of the ESRC will be the President of the ECB, national central bank governors, the chairmen of the European Supervisory Authorities and a representative of the Commission. Each central bank governor will be accompanied by one senior representative of the national supervisory authorities as observer. Decisions of the ESRC will be taken by a simple majority. The de Larosière report recommends that the chairperson of the ESRC should be the ECB President. A small steering committee will prepare and administer ESRC meetings. The ECB will provide the Secretariat to the ESRC, as well as analytical, administrative and logistic support.

The ESRC will issue warnings and recommendations, whether of a general nature or to individual Member States, with a specified timeline for the relevant policy response. These warnings and/or recommendations will be channelled through the ECOFIN Council and/or the new European Supervisory Authorities. The ESRC will also be responsible for monitoring compliance with its recommendations, based on reports from the addressees.

The ESRC will not have any legally binding powers. However, the ESRC may be expected to exert major influence on the addressees of warnings/recommendations through the high quality of its analysis. The ESRC will decide in each case whether a recommendation should be kept confidential.

The European System of Financial Supervisors (ESFS) will consist of three new European Supervisory Authorities, i.e., a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA.) These new European Supervisory Authorities will take on all the missions of the current Committees of Supervisors, but in addition exercise increased responsibilities, defined legal powers and greater authority. They will also contribute to the development of a single set of harmonised rules, improve the supervision of cross-border institutions by developing common supervisory requirements and approaches and help settle possible disputes between national supervisors.

The focal point for day to day supervision will remain at the national level, with national supervisors remaining responsible for the supervision of individual entities, for example with respect to capital adequacy. This reflects the contemporary reality that the financial means for rescuing financial institutions remains at the Member State level and with national tax payers, as the current crisis has demonstrated. The chairpersons and secretary generals of the European Supervisory Authorities are expected to be full-time independent professionals. The chairpersons will be nominated after an open competition. The appointments will be confirmed by the European Parliament and will be valid for five years. The European Supervisory Authorities' decisions on technical rules will be taken, through the board structure, **by qualified majority** based on the Treaty weighting for Member States. The European Supervisory Authorities will be accountable to the Council, the European Parliament and the European Commission.

The main tasks of the Authorities will be the following:

1. To ensure a single set of harmonised rules throughout the Union, by developing binding technical standards in specific areas and on the basis of criteria which will be specified in Community legislation; and drawing up interpretative guidelines.
2. To ensure the consistent application of EU rules.
3. To ensure a common supervisory culture and consistent supervisory practice.

4. To exercise full supervisory powers for some specific entities, such as credit rating agencies and EU central counterparty clearing houses.
5. To ensure a co-ordinated response in crisis situations.
6. To collect micro-prudential information.
7. To undertake an international role on behalf of the European Union.
8. To ensure that decisions taken under the above mechanisms do not directly impinge on the fiscal responsibilities of the Member States.

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