



ADAM SMITH  
INSTITUTE

# Financial Regulation

What is the best solution for the EU?

By Tim Ambler & Keith Boyfield

## Executive Summary

This paper responds to the EU consultation papers *Communication from the Commission, European financial supervision, {SEC(2009) 715} {SEC(2009) 716}* and the accompanying Impact Assessment *{COM(2009) xxx final} SEC(2009) xxx}*. The Adam Smith Institute's ID number is 50420071951-56

### Proposed new supervisory superstructure

The *Communication* proposes a revised superstructure for financial services as two new linked entities, a European Systemic Risk Council (ESRC) and a European System of Financial Supervisors (ESFS) respectively to provide:

- 'Macro-prudential supervision', i.e. helping to ensure overall and/or by country financial stability
- 'Micro-prudential supervision', i.e. supervision, largely left with member states under EU direction, and rule-setting, regulation, by the ESFS or one of its three subsidiary bodies.

The ESRC, chaired by a nominee of the European Central Bank, in essence brings central bankers together to share and develop best practice. In principle this is sensible, though some issues need further reflection and development, such as the relationships between EU and international or global structures. However, adding superstructure without addressing the fundamentals may be counterproductive and increase instability.

The ESFS, proposal is not justified. The Impact Assessment (IA) that should support the transfer of regulating from Member States to this new executive body, fails to do so.

### Basis of our response

Our analysis is on the basis of what financial services regulation would be best for the EU taken as a whole.

London is the only truly global financial services market in the EU and under threat from the US, Switzerland and the Far East. Rules that weaken London in competitive terms also weaken the EU. The IA fails to analyse the proposed changes, both in terms of the cost to the EU arising from this potential reduction in competitiveness and in terms of any gains for consumers or otherwise. The proposals may also be in conflict with the Lisbon Treaty, which indicates that such regulation should remain with Member States.

We welcome an EU approach to ensuring that the financial crisis does not occur again. The whole EU will benefit from the right responses. Since the UK has far the widest and most diverse experience in the financial services sector, the EU as a whole will gain by encouraging the UK proactively to take the lead on behalf of all Member States.

The main cause of the crisis was *inadequate supervision by the supervisors*. Malpractice took place over several years, as was widely known, but supervisors failed to act. This *Communication* turns a blind eye to the whole of that regulatory failure, leaving national supervision substantively unchanged. Instead of dealing with the fundamental problem, the Commission is instead proposing to add new bureaucratic structures in other areas.

Our response indicates ten areas where the IA is inadequate and concludes that the proposals seem opportunistic, using the financial crisis to provide an opening for long-held political objectives. We do not accept the idea that it is a 'knee-jerk response'. The documentation is too well prepared for that.

On the positive side, we agree both with the necessity of soon resolving the host/home issue, which certainly contributed to the crisis, and with tidying the existing Lamfalussy Committees, whose roles and overlaps need resolution.

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## Recommendations

Accordingly we make the following alternative proposals which would help to achieve the objectives of financial stability and the evolution of common standards of financial services regulation and supervision but with less damage to competitiveness:

For the ESRC, we recommend that:

- The EU recognises that issues of financial stability exist primarily within Member States as distinct from cross-border. At present these proposals are built on a false, cross-border, premise. Clearly, Member States will be sensitive about EU intervention in their domestic matters and, equally clearly, the ECB has a valid interest in financial stability within Europe. We recommend that the new system is recast to work from the bottom up, not top down.
- The proposals are reconsidered in the light of international developments beyond EU borders, e.g. the G20, the US and the Far East. EU developments should be in harmony with this wider picture. Achieving global financial stability will bring financial stability more securely to the EU.

Our ESFS recommendations are that:

- The Committee and its three subsidiaries should be chaired by representatives of the City of London, since that has by far the most experience, expertise, size and diversity of financial services. This is the same rationale as the ECB chairing the ESRC.
- The ESFS should become a consultative body with a brief cooperatively to progress financial regulations to common standards internationally and therefore also within the EU. It should work with national and international accountancy standards setters as well as national financial services regulators and supervisors.
- The EU should conduct a thorough investigation into the causes of the financial crisis and what arrangements should now be put in place to mitigate similar occurrences in future. Although it is clear that the failures were more due to poor supervision than regulation, Basel II is one part of regulation that may be to blame. Retail banking may need to be separated from investment banking; but, for competitive reasons, that would have to be done internationally and negotiation would be slow. These financial shocks only happen every 60 years and we have plenty of time to be sure we have the right answers. Rushing into the supposed solution set out in the *Communication*

would bring a false security.

- The conclusions from the analysis of causes should be published and actively discussed with all those responding to this *Communication*, as distinct from passively receiving their responses, before considering new legislation. For example, the Commission should convene a Causes of Crisis Conference, encouraging a diversity of contributions from the podium, before leaping to its own conclusions. So far we have been presented with solutions unrelated to the real problems.
- The objective should be to improve regulation and supervision at Member State level and their convergence toward global, as distinct from EU, best practice. The history of the convergence of accounting standards provides a role model for the rule-making part of that. It is fallacious to believe that processes and rules can be imposed from outside and yet be followed with enthusiasm. Achieving collective agreement may be slower and more difficult but, in the long run, implementation can be expected at a much higher standard.
- The home/host issue should be resolved on the basis of all EU Member States having supervisory responsibilities for all financial services operating in their markets, whether branches or subsidiaries and wherever they are headquartered. Home countries would additionally have responsibility for supervising the group as a whole.

## The need to clarify UK Government position

Finally, we request clarification of the Commission's understanding of the UK government's position on the *Communication*. It would appear (from President Sarkozy's comments before the recent G20 meeting, the Chancellor of the Exchequer's letter to the EU President of 3 March 2009 and the news reports following the EU leaders' summit in June 2009) that the UK government has already accepted the proposals in the *Communication*, pre-empting the consultation process. Furthermore, we understand that the Directive is to be rushed through with the enabling Member State legislation being in force in 2010.

However, Lord Mandelson has since told the British Bankers Association that Britain should seek alliances with financial sectors in other EU countries to oppose the *Communication*. He said the UK Government will defend Britain's interest, i.e. oppose the *Communication*, because 'we have more skin in this game than the rest of Europe put together'.

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The UK Government's position, in short, appears to be in contradiction. It would be helpful if the Commission clarified their understanding of UK support for, or opposition to, the *Communication*.

## Introduction

In May 2009 the European Commission published consultation documents proposing how European financial stability, regulation and supervision should be organised in future within the EU.<sup>1</sup> This consultation is one of four EU legislative responses to the recent financial shocks that have gripped the world's capital markets. The Commission claims that 'nationally based supervisory models have lagged behind the integrated and interconnected reality of today's European financial markets, in which many financial firms operate across borders'.

Since the financial markets were plunged into crisis, the European Commission has played an important role in co-ordinating the moves made by Member States to support their banking sectors, most notably through providing taxpayer funding to guarantee the continued operation of certain banking groups such as RBS, HSBC, Fortis and a clutch of Irish banks. One of the key aims of the Commission has been to ensure, as far as possible, that the financial institutions that received state support were not placed at a competitive advantage to rivals.

This paper is a response to the Commission's consultation, which sets out a range of recommendations on how financial regulation within the EU should be reformed. As the consultation notes, the Commission's recommendations are based on ideas put forward by a high level group of experts chaired by Jacques de Larosiere. These recommendations aim to strengthen cooperation and co-ordination between national financial supervisors but also set out plans for a raft of new European supervisory authorities as part of two linked EU-wide bodies charged with overseeing risk in the financial system as a whole.

The timetable for these envisaged reforms is ambitious. Following consultation, the Commission plans to push through the necessary legislation this autumn in time for the launch of a new supervisory framework regime in 2010.

### Our overall approach

We take the perspective of the EU as a whole, not the narrower perspective of any part of the EU, and set out what we believe to be the best (or least damaging) EU

organisational response to the financial crisis. Policy makers need to bear in mind the wide diversity and states of development of the financial sectors in Member States, and the large share represented by the sophisticated London market. If the best is to be achieved for the EU as a whole, policy should aim to evolve higher standards, rather than impose a 'one size fits all' arrangement on very diverse markets.

The outcome needs to be growth for the EU in an increasingly competitive international marketplace. Internal fighting over EU Member States' shares of the financial-sector cake is only likely to make it smaller. Consumer protection, risk minimisation and financial stability all have to be balanced against maintaining the competitive strength of the EU financial market relative to New York, Switzerland and the rapidly growing Asian financial markets.

We welcome an EU approach to ensuring that the financial crisis does not occur again. The whole EU will benefit from the right responses. Since the UK has far the widest and most diverse experience in the financial services sector, the EU as a whole will gain by encouraging the UK proactively to take the lead on behalf of all Member States.

### How this paper is organised

Section 1 of this paper sets out and then critiques the Commission's *Communication* proposals; Section 2 does the same for the accompanying Impact Assessment.<sup>2</sup> Section 3 does the same for the British government's approach. The June 2009 House of Lords report on EU Financial Regulation has proved valuable in this regard and we draw on their recommendations for this paper.<sup>3</sup>

Section 4 depicts what seems to us to be the best case scenario, and summarises the areas where we agree with the *Communication* and then makes recommendations for improvement. In principle, the single market requires just one set of regulations, i.e. at EU level. A bigger ideal is for one set of regulations to cover the global financial services sector. While those together should remain a long-term goal, the proposals in the *Communication* seem likely to delay the realisation of international conformity relative to the alternative that we propose. We should be looking for the highest common factor, not the lowest common denominator. The Commission's proposals threaten the prosperity of the European financial services sector and thereby the prosperity of Europe as a whole.

Interestingly, both the EU and UK arguments are remarkably free of figures. There is no formal analysis

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of the advantages or disadvantages, except in the rather narrow specific area of whether the home or host country should have supervisory responsibility. Costs and benefits of substantive alternatives are not quantified, perhaps because no substantive alternatives are presented. They ignore, for example, the effects on competition, the growth of the EU financial services market and the relative sizes of the Member States' financial services markets. In practice this means that in pursuit of some vague ideas about fairness both the EU and British proposals give (for example) Latvia the same representation as the UK.<sup>4</sup> We substantiate these charges in detail in our critique of the Impact Assessment.

## 1. The new arrangements for financial regulation proposed by the EU

The *Communication* is effectively an early draft of a proposed Directive. The intention is for its rapid development with the consequential legislation agreed in the autumn and implemented in 2010. Since financial crises of this scale come along only every sixty years, there is no economic reason for this haste. Perhaps the urgency is political: to capture internal EU political advantage, or change the financial system while it is too weak to object.

In identifying the problems associated with the current financial crisis, the *Communication* asserts that failures across Member State boundaries, rather than failures within Member States, justify the proposals. There is no attempt to validate this view nor to show why these proposals would have any impact on future cross-border failures.

We take an entirely different view. We see no evidence to suggest that the key failure behind the financial traumas experienced over the last two years was a failure of cross-border supervision. Some confusion about the jurisdiction of national supervisors over foreign-owned local operations, e.g. Landsbanki, did indeed add to the problems, but that was a failure by national supervisors to clarify matters, not something that happened because there was no EU-wide authority. At all times, national supervisors have been free to communicate with one another. Such communications do not require regulation.

Nevertheless, existing EU supervisory arrangements leave a lot to be desired and the *Communication* helps to tidy things up.<sup>5</sup> The proposals are mainly to create two new entities, a European Systemic Risk Council (ESRC)

and a European System of Financial Supervisors (ESFS) respectively to provide respectively:

- 'Macro-prudential supervision', i.e. helping overall and/or by country financial stability
- 'Micro-prudential supervision', i.e. regulation and supervision of individual firms.

### The European Systemic Risk Council

This initiative seems like an attempt to 'keep up with the Joneses'. The G20 is establishing much the same entity, the Financial Stability Board (FSB), with a global remit; meanwhile the US is establishing a national body to address the same goal.

In the case of the UK this role lies with the Bank of England. The Bank complains that it has not had the tools to monitor and enforce financial stability: that, however, is a purely UK matter. Internationally, if we have financial stability for the leading economies that make up the G20, we do not need to duplicate this role at EU level.

The secondary rationale (see page 4 of the consultation) is that: 'These fragmented arrangements [i.e. the existing EU arrangements] must change because the economic costs of failure in macro-prudential supervision, as this crisis has shown, can be heavy.' This is a non-sequitur. Since the failures of supervision were internal at the national level, the onus is on the Commission to produce tangible evidence that the revised arrangements would make any difference, especially given the new FSB.

On page 5, the consultation outlines the role of the ESRC as being to:

- collect and analyse all information relevant for monitoring and assessing potential threats to financial stability that arise from macro-economic developments and developments within the financial system as a whole;
- identify and prioritise such risks;
- issue risk warnings where risks appear to be significant;
- where necessary give recommendations on the measures to be taken in reaction to the risks identified;
- monitor the required follow-up to warnings and recommendations, and
- liaise effectively with the IMF, the FSB and third country counterparts.

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It is not clear from the consultation whether this refers to the financial stability of the EU as a whole and/or Member States. So far as Member States are concerned, there is certainly room for an international body to monitor national authorities, such as the Bank of England, and nudge them where their action is seen as inadequate. The crucial question is what value is added in having this done by an EU body, in addition to the IMF, FSB and OECD.

The proposal that the ESRC would be purely advisory and not prejudice Member States' financial stability arrangements seems reasonable. The ESRC may be a wasteful new bureaucracy, but it is small by EU standards, it replaces some of the existing confusion and it does not appear to be a threat to the EU financial services sector.

### The European System of Financial Supervisors

The main rationale here is that multinational companies require multinational supervision. In other words, there are gaps between EU Member States, which national regulatory authorities cannot supervise adequately. This is a fallacy: the total EU financial services industry is the sum of EU Member State financial services. Indeed, the EU proposes to leave supervision (with few exceptions, such as credit agencies) with Member States. The confusion arises because of cross-border *ownership*; and this is not the same thing at all.

According to the Impact Assessment 'The host country has to recognise supervision from the home country authorities on most prudential issues' (see page 9). In other words, country supervisors would have little or no jurisdiction over the operations of the local branches of a group that was headquartered elsewhere. This is plainly inadequate.

The tax authorities in all countries have faced similar problems. They collect taxes based on the country of trading operations, using invoiced sales, not the location of headquarters. In our response to FSA 09/2, we proposed that this issue should be clarified on a similar basis: that jurisdiction was based on the country of operations, i.e. invoiced sales, irrespective of the country of ultimate ownership.<sup>6</sup>

The secondary rationale, on page 14, provides no evidence in support. The *Communication* states, 'Deeper and more integrated financial markets offer better opportunities for financing and risk diversification, and thus help to improve the capacity of the economies to absorb shocks. Financial integration and stability are therefore mutually reinforcing.' But why will a single supervisor make a market deeper

or more stable? On the contrary, the recent crisis has demonstrated that instability has been proportional to market size.

It is envisaged that the ESFS will be divided into three parts, 'which would each have legal personality', namely the:

- European Banking Authority (EBA),
- European Insurance and Occupational Pensions Authority (EIOPA), and
- European Securities Authority (ESA).

The ESFS, with its three subsidiaries, is proposed as a fully executive, pan-European firm-level regulator, though working through the Member State supervisors such as the FSA. It will create a single set of rules across all Member States and ensure they are consistently applied. It will have the final word on disputes between Member State supervisors and create a 'common regulatory culture and consistent supervisory practices' (see page 9). It will directly supervise some firms, i.e. 'be given the responsibility for the authorisation and supervision of certain entities with pan-European reach, e.g. credit rating agencies and EU central counterparty clearing houses' (page 10). It will also ensure a 'coordinated approach' in crisis situations.

In short, this body will have immense powers. It would regulate and supervise a fully federalised EU financial services sector. Scant attention is paid to the principle of subsidiarity. Furthermore, voting weights will not be proportional to the size, importance, experience, expertise, diversity of the Member States' financial services sectors.

A single set of rules is logical for a single market, and we have long advocated that as a guiding principle. But moving straight away to that goal without any transitional arrangements would compromise the competitiveness of EU financial services, and the overall prosperity of the EU as a whole.

(Some cynics suggest that the subtext of these French-inspired and German-supported proposals is to reduce the competitive advantage of the UK to the benefit of other EU Member States. If so, this approach seems likely to weaken EU financial services as a whole, relative to the US, Switzerland and the Far East.)

The legal support for the *Communication* appears shaky. Having made it clear that ESFS and its three subsidiaries are fully executive, the *Communication* then shifts its ground. On page 14 it notes that these bodies will be merely



advisory since that is all that is permitted under the (as yet to be ratified) Lisbon Treaty. Legally it is ‘a “Community body responsible for contributing to the implementation of a process of harmonisation”, when the tasks conferred on such a body are closely linked to the subject-matter of the acts approximating the national legislations.’ This interpretation raises the suspicion that in legal terms subsidiarity should prevail, but the *Communication* conveniently chooses to ignore that fact.

## 2. The EU Impact Assessment (IA)

EU Impact Assessments (IAs) should set out a range of issues, namely what are the policy objective(s) and the alternative methods by which they can be achieved, both through regulation and non-regulatory means. In addition, IAs should identify the advantages and disadvantages, costs and benefits of each method relative to doing nothing.

With regard to this *Communication*, the overall problem or policy objective to be addressed is summarised on pages 7-8. Here it states:

*In summary, the crisis exposed that the arrangements for financial supervision in the EU can create risks to stability through the mismatch between the level of European integration of EU financial markets and the national organisation of supervisory responsibilities.*

*The seriousness of this problem is magnified given the other weaknesses exposed by the crisis:*

- *Increased risks of cross-border contagion for EU financial markets linked with the increased integration, both throughout the EU and with global financial markets.*
- *Undermined confidence of consumers, employees, pensioners, small business and retail investors contributing to the economic recession.*
- *Reduced global competitiveness of the European financial industry, compared with what would have been the case with better supervisory practices.*
- *Risks of uncoordinated policies driven by national interest with negative impact on the Single Market.*

*These general problems are common to both micro-prudential supervision and macro-prudential supervision.*

The five potential firm-level solutions for these problems, according to the Impact Assessment, are:

- *The status quo:* This is confused as to home and host country jurisdiction with multiple EU level advisory groups.
- *Host country supervision:* ‘Under this option the model of host country supervision adopted in the 1970s would be restored. The First Banking Directive (1977) granted full responsibility for supervision of banks operating in and that foreign identity could not be a ground for refusing a banking licence’ (page 18). Host country regulators had jurisdiction over branches but not subsidiaries, which stayed with the group’s home country supervisor. ‘However, it would be inefficient as every branch would have to pledge (additional) capital and it would not solve the problem of inadequate co-operation among supervisors in the context of cross-border banks. Furthermore, over time divergence of supervisory approaches might lead to increased risks to financial stability.’
- *Lead supervisor:* The home country supervisor, i.e. of the group’s headquarters, would supervise in all countries of operation.
- *The de Larosière proposal: European System of Financial Supervisors (ESFS):* As discussed in this paper.
- *The Single Market option:* Treating financial services as a single market with a single EU supervisor in place of both EU and national ones.

### Our comments on the IA

It is clear that national supervisory authorities, not just the FSA, are in a muddle about home/host country jurisdiction. The legal distinction between a branch and a subsidiary is not substantive. Our previous paper addressed this issue and recommended that all those firms operating within a single Member State’s jurisdiction, irrespective of any foreign affiliations, should be subject to host country supervision.<sup>7</sup> That generates some duplication in the home country, which has to consider both the group’s overall compliance and its domestic operations, but this is not necessarily a bad thing.

The fact that multinationals would have to observe different rules in different countries is no objection. The *Communication* does not propose moving to a single

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market, so different rules will continue to apply in any case. Nor do we see our recommendation as contrary to the First Banking Directive (1977), which banned different treatment for foreign-owned banks. We propose equal treatment within a market irrespective of the location of ownership.

Most of the argument in the Impact Assessment, and the alternative solutions presented, are built on this home/host confusion. This is obfuscated by referring to the home/host issue as 'cross-border.' For example, Landsbanki was a problem for the UK not because of cross-border transactions but because the FSA failed to supervise Landsbanki's UK operations. In other words, the host country failed to supervise Landsbanki on the grounds that it was a matter for the home country, namely Iceland. So this *was* a home/host issue, but it *did not* arise as a cross-border issue. British investors were not investing in Iceland, but in the UK.

The home/host issue does indeed need resolution, and we will recommend how, but cross-border issues do not. Removing the home/host problem causes all the alternatives to de Larosière to fall away: they are straw men presented only to justify the EU proposals. The IA should propose genuine alternatives to deal with the real cause of the financial crisis, namely the failure of national supervisors to supervise.

We have ten specific objections arising from our analysis of the IA:

- The IA ignores developments on the global front. Given the new G20 agreement on the Financial Stability Board (FSB), do we need the intermediary (EU) level of integration at all? For example, will the EU have just one seat on the FSB – as the US, for competitive reasons, will no doubt suggest?
- The IA does not compare genuine alternatives nor quantify costs and benefits. What impact, for example, will the de Larosière solution have on the competitiveness of the EU with respect to the US, Switzerland and Far East financial centres?
- Arguments for the ESRC, e.g. challenging supervisory practices, are wrongly adduced to supporting the ESFS proposals.
- We do not agree that the ESFS proposals on micro-prudential supervision would improve crisis management, since they are primarily about rule writing. Regulation as such is not the answer and may even exacerbate crises.<sup>8</sup> Furthermore the present

crisis arose within markets, not across borders.

- The efficiencies from common rules are also overstated, since each firm has to deal separately with each Member State supervisory body.
- The level playing field argument and the advantages of a single financial services market are accepted for the longer term but, as the IA acknowledges, they are not feasible in the short term. Some differences may even increase the EU's competitive advantages in the short term since they allow different solutions for Member States to maximise their markets and thus the EU market as a whole.<sup>9</sup>
- The IA makes bold claims for support from empirical evidence (see page 31), which is not referenced or shown in the IA, but which is said to show, unsurprisingly, that financial stability at the national level promotes prosperity. But this does not mean that the de Larosière proposals will increase financial stability: they may simply add to the weight of the bureaucratic superstructure without bolstering the foundations at country level, drawing the focus of supervisors away from their own markets.
- The arrangements for monitoring and evaluating the success of the new proposals are vague in the extreme (page 40). No specific key performance or success indicators are shown. The opening paragraph says 'A number of indicators are applied to monitor the trends related to the General Objectives of the reform: financial stability, consumer and business confidence, international competitiveness of EU financial industry, financial integration.... However, it is difficult to establish the degree to which the EU policies, in particular the reform of financial supervision, influence the evolution of these indicators.'
- On proportionality and subsidiarity, there appears to be some doubt as to whether the proposals are entirely consistent with the Lisbon Treaty, and whether an EU supervisory body can issue binding rulings or decisions to national supervisors.<sup>10</sup> However, this is a legal point and could be overcome by unanimous agreement of the Member States.
- Finally, and of greatest concern, the IA does not analyse the reasons for the financial crisis, nor does it show why these new arrangements will mitigate them (except for the home/host problem. It reads as if the crisis provides an excuse to promote long held desires for central financial control, rather than as a reasoned set of solutions to the causes of the crisis. Resolving the home/host issue is important, but it is a simple problem that does not require the elaborate superstructure of the *Communication* to solve it.

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### 3. Counter-proposals by the UK government and House of Lords

The FSA and HM Treasury made a joint response to the de Larosière proposals in March 2009. Their websites do not reveal what the response was, but its tenor can be assessed from the Chancellor's letter of 3 March to the President of the EU and from a speech by a senior FSA executive.<sup>11</sup> The letter broadly supports the proposals with only nuanced variations. For example, it argues that the new central rule-making body should be answerable to the Council of Ministers, not the Commission. However, it is not clear why removing the Commission from its charge would help matters.

Another nuance is that progression to an executive rule-making body should be gradual: 'Over time, this body should become the source of technical rules rather than national authorities or the Commission'. We agree that an evolutionary approach would be better but we understand that the UK Government has since withdrawn their objection.

The UK government counter-proposed that the ESRC should not be chaired or dominated by the European Central Bank, since that would bias findings in non-Euro countries.<sup>12</sup> We do not agree: as the largest interested party by far, the ECB should have the main say. Equally, the UK Government should insist that representatives of the City of London should chair the ESFS and its three subordinate committees.

The problem with the ESFS is not its independence, as the UK Government argues, but its executive authority. Whether it reports to the Commission or to the Council of Ministers is not of great importance.

The House of Lords, following a thorough and extensive investigation of these proposals, reprimanded the government for its inadequate and contradictory evidence to the EU committee on the future of EU financial regulation and supervision.<sup>13</sup> We agree with most of their 25 recommendations (attached as an Appendix) and would be interested to know which the UK government does, and does not, agree with too.

The only recommendations that seem contentious are:

*240. The House of Lords EU Committee was more generous to the de Larosière proposals than we have been. We disagree with the conclusion that*

*'the de Larosière report made a powerful case for reform when it identified weaknesses and failures of micro-prudential supervision of financial services in the single market'. We do not see how such a conclusion is justified.*

*243. The Committee objects to the increased powers for host countries, which we support. They see this as a retreat from the single market and the emergence of protectionism. The logic of this escapes us: whether supervision is lodged with the host in one EU Member State or the home Member State makes no difference at the EU level. Furthermore, home responsibility for firms headquartered outside the EU but with branches inside the EU, e.g. Landsbanki, was a direct contributor to the crisis and the major issue where we agree with de Larosière. See our recommendation below.*

*245. This sees an additional EU role, presumably to all Member States not just the UK, at the G20 and global (IMF) summits. It is hard to see how other countries, notably the US, would agree to that proposal. Either the regulatory powers have been handed to the EU and Member States need not attend [as in the case of the World Trade Organisation (WTO) talks] or the powers remain with Member States and the EU need not attend. Of course, that would not stop formal EU advice being presented at any international meeting.*

Finally, we request clarification of the Commission's understanding of the UK government's position on the *Communication*. It would appear, from President Sarkozy's comments before the recent G20 meeting, the Chancellor of the Exchequer's letter to the EU President and the news reports following the EU leaders summit in June 2009, that the UK government has already accepted the proposals in the *Communication*, pre-empting the consultation process.

On the other hand, Lord Mandelson has since told the British Bankers Association that Britain should seek alliances with financial sectors in other EU countries to oppose the *Communication*.<sup>14</sup> He said the UK Government will defend Britain's interest, i.e. oppose the *Communication*, because 'we have more skin in this game than the rest of Europe put together'.

The UK Government's position, in short, appears to be in contradiction. The House of Lords came to a similar



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conclusion in June. It would be helpful if the Commission clarified their understanding of UK support for, or opposition to, the *Communication*.

#### 4. What are the best arrangements for EU financial regulation?

We substantially agree with the de Larosière proposals so far as the macro-level, i.e. the ESRC, is concerned. We also agree with the proposed structural revision to the existing Lamfalussy committees and that supervision should operate for both host and home firms. In other respects, the attempt to use a high-level superstructure to deal with low-level problems is simply misguided. The wrong tools are being used for the purpose.

For the ESRC, we recommend that:

- The EU recognises that issues of financial stability exist primarily within Member States as distinct from cross-border. At present these proposals are built on a false, cross-border, premise. Clearly, Member States will be sensitive about EU intervention in their domestic matters and, equally clearly, the ECB has a valid interest in financial stability within Europe. We recommend that the new system is recast to work from the bottom up, not top down.
- The proposals are reconsidered in the light of international developments beyond EU borders, e.g. the G20, the US and the Far East. EU developments should be in harmony with this wider picture. Achieving global financial stability will bring financial stability more securely to the EU.

Our ESFS recommendations are that:

- The Committee and its three subsidiaries should be chaired by representatives of the City of London, since that has by far the most experience, expertise, size and diversity of financial services. This is the same rationale as the ECB chairing the ESRC.
- The ESFS should become a consultative body with a brief cooperatively to progress financial regulations to common standards internationally and therefore

also within the EU. It should work with national and international accountancy standards setters as well as national financial services regulators and supervisors.

- The EU should conduct a thorough investigation into the causes of the financial crisis and what arrangements should now be put in place to mitigate similar occurrences in future. Although it is clear that the failures were more due to poor supervision than regulation, Basel II is one part of regulation that may be to blame. Retail banking may need to be separated from investment banking; but, for competitive reasons, that would have to be done internationally and negotiation would be slow. These financial shocks only happen every 60 years and we have plenty of time to be sure we have the right answers. Rushing into the supposed solution set out in the *Communication* would bring a false security.
- The conclusions from the analysis of causes should be published and actively discussed with all those responding to this *Communication*, as distinct from passively receiving their responses, before considering new legislation. For example, the Commission should convene a Causes of Crisis Conference, encouraging a diversity of contributions from the podium, before leaping to its own conclusions. So far we have been presented with solutions unrelated to the real problems.
- The objective should be to improve regulation and supervision at Member State level and their convergence toward global, as distinct from EU, best practice. The history of the convergence of accounting standards provides a role model for the rule-making part of that. It is fallacious to believe that processes and rules can be imposed from outside and yet be followed with enthusiasm. Achieving collective agreement may be slower and more difficult but, in the long run, implementation can be expected at a much higher standard.
- The home/host issue should be resolved on the basis of all EU Member States having supervisory responsibilities for all financial services operating in their markets, whether branches or subsidiaries and wherever they are headquartered. Home countries would additionally have responsibility for supervising the group as a whole.

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## Endnotes

- 1 For the purpose of this paper, 'regulation' refers to rule-making and 'supervision' refers to the monitoring and enforcement of those rules.
- 2 *Communication from the Commission, European financial supervision*, [SEC(2009) 715] [SEC(2009) 716] and the accompanying Impact Assessment [COM(2009) xxx final] SEC(2009) xxx.
- 3 House of Lords, European Union Committee, 14th Report of Session 2008–09, *The future of EU financial regulation and supervision*, Volume I: Report, 17 June 2009.
- 4 Both suggest a rule-setting authority with one representative per member state.
- 5 Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR), also often known as the 'Lamfalussy level 3 Committees'.
- 6 Tim Ambler and Keith Boyfield, *Regulatory Myopia: A response to Financial Services Authority DP09/2*, Adam Smith Institute, June 2009.
- 7 *Ibid.*
- 8 Tim Ambler, *The Financial Crisis: Is regulation cure or cause?* Adam Smith Institute, October 2008.
- 9 See footnote 27 of the IA which reads: 'See the G30 report, *The Structure of Financial Supervision – approaches and challenges in a global marketplace*. G30, 9/10/2008, which states "In general, no one model has proven unambiguously superior in achieving all the objectives of regulation."'
- 10 See paragraphs 233 and 235 of the House of Lords European Union report of 17 June 2009.
- 11 Speech by David Strachan, Director, Financial Stability, FSA, ICFR Inaugural Summit, London 1 April 2009: 'Finally, The Turner Review concludes that the current EU system is unsustainable. The basic framework underpinning the EU is that there should be a single market for goods and services, including for financial services. However recent events, particularly the failure of Lansbanki [sic], show that single market rules can create unacceptable risks for depositors – and ultimately taxpayers in one Member State – because of shortcomings in another Member State. The question, as posed by Lord Turner, is whether we have more Europe or less Europe. In The Turner Review the answer proposed is both. How many more national powers are required will depend on how effective 'more Europe' options can be. For 'less Europe' we recommend more national powers for Member States hosting branches, particularly in the oversight of capital and liquidity for banks operating in their country. For more Europe the FSA would like to see a debate on deposit insurance for cross-border banks and the establishment of a new EU body. Our vision for this body is

set out in more detail in slide 13. It would replace the Lamfalussy [sic] Committees, be an independent body that would have rule-making powers and have oversight of regulation within the EU. However, we continue to believe day-to-day supervision should remain at national level. The proposal by the UK to establish such a body may have surprised some of you. In my view it highlights just how much the crisis has changed the regulatory landscape. We believe that such a body represents the most viable alternative to more fundamental 'less Europe' options.'

- 12 What the Chancellor actually wrote to the President of the EU on 3rd March 2009, but note the "alongside", was: "It is right that the ECB should play an important role in this independent body, alongside the central banks in non-euro countries such as the Bank of England."
- 13 Paragraph 237 puts this more delicately. House of Lords, European Union Committee, 14th Report of Session 2008–09, *The future of EU financial regulation and supervision*, Volume I: Report, 17 June 2009.
- 14 Carl Mortishead and Gary Duncan, 'Mandelson warns that banks may lose appetite for reform as economy starts to recover,' *The Times*, p.38, 29 June 2009.

## About the authors

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## Appendix: House of Lords Report on 'The future of EU financial regulation and supervision', June 2009

### CHAPTER 10: SUMMARY OF CONCLUSIONS

#### The future of financial regulation in the European Union

223. Although we welcome attempts to remove conflicts of interest and improve transparency of rating agencies, we question whether rapid action on the regulation of credit rating agencies was necessary. The degree of uncertainty over the effects of this Regulation cast doubt over whether careful consideration was given to these proposals in line with the Better Regulation principles. Concerns over the initial Commission draft of the Regulation limiting the scope for EU-registered institutions to trade in overseas financial instruments were also justified. The Regulation must avoid stifling European participation in the global trade in financial products (paragraph 56).

224. We agree that as far as possible the Commission should remove the reliance on ratings for regulatory purposes, in conjunction with similar changes to the Basel rules (paragraph 57).

225. The Commission's 5% retention requirement on complex securitised instruments is an effective compromise to limit the more excessive securitised transactions and we agree with it (paragraph 62).

226. We recommend that the Commission should work towards an overt countercyclical capital regime through further amendments to the Capital Requirements Directive. This should take place in conjunction with changes to the Basel rules to ensure international consistency (paragraph 72).

227. The introduction of a harmonised standard for deposit guarantee schemes provided a rapid solution to the dangerous distortions in the single market caused by different levels of deposit guarantees across the EU and the European Economic Area. Problems remain with the Directive and we ask the Commission to address these in its review of the Directive in December 2009 (paragraph 75).

228. We agree that there is a case for further harmonisation of rules on the winding up and reorganisation of credit institutions (paragraph 76).

229. It is imperative that the Commission properly consider the global effects of its proposals on alternative investment funds (paragraph 81).

230. The consensus of our witnesses was that the influence of alternative investment funds in the financial crisis was limited and we recommend that the Government should work to prevent proposals for EU regulations from stifling these markets. There is currently no pressing requirement for rapid EU legislative action in this area (paragraph 82).

231. Rapid action must not come at the expense of thorough consultation, impact assessment and risk analysis by the Commission in line with their own Better Regulation principles. Where necessary, the Commission should review the effectiveness of emergency legislation, to check that it is achieving its original objectives (paragraph 86).

232. We urge the Commission to ensure that proposals for new regulation of financial services in the EU are coordinated with global regulatory initiatives (paragraph 87).

#### Financial supervision in the EU: an introduction

233. We note that under the existing Treaty there is likely to be little opportunity to provide any EU supervisory body with the power to issue binding rulings or decisions on national supervisors. We also note the use of Article 105.6 requires unanimity and some Member States oppose its activation (paragraph 98).

234. The establishment of any EU body with supervisory authority and far reaching micro-prudential supervisory roles and powers to mobilise fiscal resources in the event of crisis, or passing such powers to the European Central Bank, is difficult if not impossible whilst national governments bailout financial institutions (paragraph 102).

235. While we recognise the benefits of further harmonisation, we believe that the establishment of a single supervisory authority can not happen unless there is a facility or burden-sharing arrangements on the bail-out of financial institutions at an EU level. In addition, the institution of any single EU supervisory authority would require substantial revision of the EC Treaty (paragraph 111).

#### The reform of macro-prudential supervision

236. We conclude that a new body at the EU level to assess macro-prudential systemic risks, arising from financial institutions and markets, should be supported. There must be structures in place to strengthen the likelihood of macro-prudential risk warnings from any EU-wide body leading to mitigation of risk by national supervisory bodies (paragraph 127).

237. We conclude that the Government differs from many witnesses, including M de Larosière, in its version of the role, powers and structure of a new EU-wide macro-prudential body. It

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appeared to us that the Government's thinking on those important issues was less than fully developed. We recommend the Government clarify its thinking and proposals speedily in order to contribute most effectively to the discussions on the development of a new macro-prudential supervisory structure (paragraph 143).

### **The reform of micro-prudential supervision**

238. Colleges of supervisors provide a useful forum of cooperation between supervisors and their existence is possible within the current Treaty. We welcome the move to expand colleges to all cross-border EU banks and agree provisions for meetings of core supervisors are necessary to maximise efficiency of supervisory cooperation. We recommend that while the Level 3 Committees exist (in their current form) they should provide guidance on the role of colleges. Such guidance should be provided on a flexible basis to ensure colleges are adaptable to differing and changing circumstances (paragraph 151).

239. Level 3 Committees, or a similar coordinating and standard-setting body, are well-placed to lend consistency to the work of colleges of supervisors and currently play an effective role in the supervisory structure of the EU. We welcome the Committees playing a linking role between any macro-prudential supervisory structure, national supervisors and colleges of supervisors as envisaged in the first stage of the de Larosière proposals. This role can in principle be accomplished under the current Treaty (paragraph 164).

240. The treaty and fiscal issues create significant problems for the proposal to upgrade Level 3 Committees into Authorities. However, the de Larosière report made a powerful case for reform when it identified weaknesses and failures of micro-prudential supervision of financial services in the single market (see paragraphs 165–166 of the de Larosière report). We agree that a debate on the powers of any new body is crucial for the reform of the structure and process of EU supervision. There is a need to reconcile the limitations of the EC Treaty and the location of fiscal authority with the need to improve upon micro-prudential supervision of the single market. We recommend the Government set out in further detail its own proposals for achieving this (paragraph 166).

241. We agree that the question of whether the new Authorities should remain as three separate institutions or merged into two or one institution is not the relevant issue. It will be crucial to establish close working procedures in all proposals, but still have an understanding of particularities of the three areas of banking, securities and insurance. The proposal of the UK Government

should begin an important debate over what structure any coordinating supervisory body at EU level should take (paragraph 173).

242. The creation of colleges of supervisors and the increase of the role of the Level 3 Committees in providing a forum for cooperation and information sharing between national supervisors are to be welcomed. They offer pragmatic steps to greater coordination of supervision within the EU that do not require Treaty amendment or provide difficulties over the location of supervisory authority (paragraph 178).

### **Home/host country supervision**

243. The call for increased powers for the host supervisor must not lead to a retreat from the single market and the emergence of protectionism. We recommend that there should be no shift of power to the host country supervisor. Colleges of supervisors must provide an effective forum in which legitimate concerns and responsibilities of home and host supervisors can be resolved within the clear framework of a single market in financial services. It is clear that there are difficulties in achieving this, and it remains a matter of real concern to us (paragraph 195).

### **The role of the EU in global supervision and regulation**

244. The IMF's surveillance role should be expanded, whilst a well-resourced FSF/FSB should continue to operate as an international standard setting body helping mitigate the risks outlined by the IMF (paragraph 203).

245. We recommend the Government to work towards an EU statement at G20 meetings and the Commission to coordinate EU regulation with international responses. The EU can play a leading role in producing well considered reforms that can provide a standard for global solutions, as long as it recognises that all regulation must be in coordination with global initiatives (paragraph 205).

### **State aid in the financial crisis**

246. We welcome the flexible, rapid and pragmatic approach demonstrated by the Commission in applying state aid rules (paragraph 215).

247. We recommend the Commission to be vigilant in their assessment of restructuring plans in order to minimise the threat to the single market posed by state aid. The Commission must ensure that a viable time-based exit strategy is produced and followed for those institutions that receive state aid. State aid should be the exception and not the norm (paragraph 222).