Restoring Confidence

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Karel Lannoo

In the follow-up to the European Council last week, the European Commission, in close cooperation with the national governments, urgently needs to start a new 'financial services action plan' to restore trust in Europe's financial markets, and upgrade the current framework. The various national plans to unlock the interbank market or to take equity positions in undercapitalised banks are not sufficient in themselves. As mistrust in the financial system has spread to ordinary citizens, a broad institutional and regulatory plan needs to be put in place to convince them that policy-makers have learned the necessary lessons from this crisis. The single market has backfired against the EU, as prudential standards were not sufficiently harmonised and those consumers who ventured outside their home banks were often penalised.

Until the Eurogroup meeting took place in Paris on October 12th, the EU had been, for ordinary citizens, absent from the financial crisis. The response to the crisis until that moment had been in the hands of national governments. The Eurogroup was the first meeting at European level to come up with an action plan in the form of closer coordination between the eurozone countries to stabilise their financial sectors. This approach was confirmed by the European Council a few days later. What is lacking so far, however, is a robust plan to demonstrate how similar crises will be avoided in the future. A new 'financial services action plan' should therefore be designed, with above all the broader public in mind. This new plan should launch initiatives in the prudential, institutional and product harmonisation domains.

On the prudential side, it is clear that the Basel ratios have not provided a clear indication of the true level of risks in banks. European supervisors have focused far too narrowly on one measure, the risk-weighted capital ratios as proposed by the Basle Committee, which allowed banks in trouble to claim they were solvent. The Belgian bank Dexia is a case in point. While the bank had a Basel Tier 1 ratio of 11.4% in June 2008, it had a core capital ratio (core capital divided by all – not risk-weighted – assets) of only 1.6%! This is well below the 2% closure rules used by US supervisors. The use of the Basel ratio should thus in the future be complemented with a crude capital (or leverage) ratio, a liquidity ratio, an asset diversification ratio and a governance index, as key indicators of the soundness of a bank. The recapitalisation of banks should be directly linked to a firm commitment by the banks to meet minimum levels by a certain time.

Karel Lannoo is Chief Executive at CEPS. This article is based upon his presentation at the "1st International Santander Banking Conference", held in Madrid on 16 October 2008.

On the institutional side, policy-makers need to come up with a much more integrated structure for financial oversight in the EU than what is in place at present. The loose cooperation structure and the limited coordination in the supervisors' secretariats have clearly shown their limitations. Banking markets are much more interconnected than are the supervisors, and the lack of stricter European-wide oversight affects the competitiveness of the European banking sector as a whole. The new Committee set up by the European Commission and chaired by Jacques de Larosière, should aim to modernise the EU's regulatory structure, through the creation of a European System of Financial Supervisors (ESFS). Under an ESFS, EU supervisors would work under a single umbrella and within a single institutional structure, on the basis of harmonised principles and statutes, but respecting subsidiarity where needed. Hence crisis management, supervision of large, systemically important institutions and data-pooling would be executed at the centre, whereas the control of consumer protection and conduct-of-business rules would be left with the member states.

The de Larosière group will also have to come up with a model for burden-sharing of failures of European-wide banks. This is no longer problematic only for the smaller countries, but also for the larger member states, where the growth prospects of the financial sector will be compromised for some time to come unless a European plan exists. The top five banks in the UK, for example, represent more than three times the country's GDP and a large part of their assets and activities are outside the UK. It would thus be prohibitively costly for the UK government to save its banking system on its own, but it would also not be appropriate as the benefits from saving UK banks would accrue to all those countries where UK banks operate.

On the product regulatory side, there is much in need of upgrading and redesign, which will become even more apparent as the dust of the crisis settles. In retail finance, for example, much work needs to be done on the deposit protection schemes, fund regulation and mortgage regulation. Further to the agreement in the Ecofin Council of October 7th, a proposal was made by the European Commission to increase the minimum level of deposit protection schemes to €100,000. But the proposal does not harmonise the statutes of the national regimes, nor does it harmonise the ways of funding. It also does not satisfactorily resolve the home-host country conflicts. Work is ongoing regarding the supervision of funds, but the current turmoil has demonstrated that the rules on eligible assets and asset segregation leave much to be desired. A new, more principles-based framework for fund management in the EU would be preferable. As for mortgage credit, more binding legislation will be needed to enforce responsible lending and the use of reasonable loan to value ratios. Apart from this regulatory fine-tuning, the European Commission's competition policy department will have a huge task in scrutinising the application of different national bail-out plans and confining the single market damage.

Some have argued that the financial crisis has set back progress in EU integration by 15 years. The EU can demonstrate that this is not the case by rapidly drawing the lessons from the crisis and taking it as a challenge for a further step in European integration. Doing so will require plenty of effort and determination, but it will certainly benefit the EU's financial services industry and economy.

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As early as April 2006, with the publication of "A world out of balance?", CEPS provided an analysis of the forthcoming problems by diagnosing a bubble in real estate markets. See: *A world out of balance?*, Special Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Thomas Mayer and Angel Ubide, April 2006