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The crisis, one year on

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For Europe, the starting point of the financial crisis was the massive liquidity injection by the European Central Bank on 9 August 2007, but it took the markets more than half a year to realise its magnitude. After experiencing steep declines in August, European stocks recovered, and several large markets reached all-time highs in November 2007. It was only from mid-January 2008 onwards that the full ramifications of the crisis started to seep through. With new loan loss provisions being announced almost every day by banks in the first half of 2008, the pessimism started to become widespread, and has, one year on, become an intrinsic feature of the financial sector, judging from the level of the interbank money market rates.

Policy-makers have not stayed on the sidelines. As the financial crisis unfolded, regulators responded at national, European and global level. One year on, some clear shifts are discernible in the institutional set-up, but they have probably not been explicitly acknowledged. At the same time, the crisis has brought to the fore important gaps in the European and global supervisory architecture.

Central banks in the driving seat. A first important shift in the institutional structure is the dominant role of central banks. In effect, central banks re-emerged as key actors, as lenders of last resort to the ailing financial system, in spite of the whittling down of their mandate over the last decade to only encompass monetary policy – the maintenance of price stability. The ECB, the Fed and the Bank of England have emerged as the core actors in the financial crisis and have managed to increase their authority. The Paulson report, published by the US Treasury in March 2008, recommended a central role for the Fed in prudential supervision, including investment banks. In his Mansion speech in June 2008, the Chancellor of the Exchequer granted an extended mandate to the Bank of England for financial stability. The ambiguous role of the ECB in financial stability oversight has not been formally clarified, but informally the bank is in the driver's seat.

The FSA model failed. The model in several European countries in which prudential supervision was moved away from the central banks to integrated financial supervisory authorities (FSAs) is no longer the benchmark. The critics of the FSA model – who complain of an excessively legalistic and box-ticking approach to supervision and one that loses sight of the broader picture – have been proven right. Keeping prudential oversight under the same roof as the central bank should allow better detection of macro-prudential risks. The Paulson report explicitly referred to the Dutch "twin peaks" model as the long-term ambition for the US. Under that structure, which has been adopted in the Netherlands, the central bank is also in charge of prudential supervision, and conduct of business control is left to a separate authority.

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Gaps in the European supervisory architecture. The crisis exposed important shortcomings in the European regulatory structure, which could undermine financial market integration. Concerns lie most notably with the diversity in the levels and methods of depositor protection in the EU. Full harmonisation of deposit insurance and other measures are nominally part of the action plan – or Roadmap – of the EU ministers of finance, but this plan lacks a clear, long-term vision and resembles more short-term plumbing. Ministers have repeatedly emphasised in their statements on the financial crisis that the present supervisory framework cannot be altered, meaning that no new grand vision is needed for supervision in the EU. One may wonder, however, whether the predominantly national supervisory system in the EU is still in line with market realities.

Markets need better tools to assess financial institutions. Most observers were not prepared for the depth of the financial crisis or the detrimental impact it had on the financial system in the EU and the US. The dire consequences for some large financial institutions were staggering. The tools to assess the soundness of financial institutions seem very imperfect, notwithstanding more than 20 years of global cooperation on banking regulation. Rather than endorsing another round of talks likely to increase the complexity of financial supervision, regulators would be well advised to think about simple tools to allow markets and the public at large to have a better appreciation of the risks inherent in the financial institutions they are dealing with. As with the Maastricht criteria for public finance, authorities should require banks to regularly disclose a set of easily understandable and comparable standards to measure the quality of their finances.[1] These could include, e.g. the regulatory capital requirement, a capital at risk and asset diversification ratio, a liquidity percentage and a governance index. Authorities should educate the public on understanding these indicators, thereby also contributing to financial education at large.

One year on, the financial crisis is far from over. On the contrary, it has become deeply rooted and is starting to affect the real economy, as the cost of credit has grown and banks have become more selective in their lending. The debates on the governance and supervision of banks can only be expected to take an even more central stage after the summer.

[1] As argued by this author in "The Maastricht Criteria for Banking", CEPS Commentary, February 2008.