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**Article**

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## EUROPE'S BANKING CHALLENGE: REREGULATION WITHOUT REFRAGMENTATION

NICOLAS VÉRON\*

The intervention by governments in October 2008 appears to have succeeded in stopping market panic about Europe's largest banks – for some time at least. The massive plan that combines liquidity and capital injections and guarantees was an appropriate reaction to the urgency of the moment. But the same urgency had the consequence that the plan was not informed by consideration of its long-term consequences. We can be sure that credit conditions will return to normal at some point in time, in a few years at the very latest. What remains entirely undetermined, however, is the shape the European financial sector will present itself in whenever the dust from this crisis settles.

There can be little doubt that the financial industry will experience significant restructuring in the meantime: market developments in late September and early October have made amply clear that its earlier structure was unsustainable. Now that the entire sector has been brought under the umbrella of government guarantee, restructuring trends are bound to depend heavily on policy decisions, whether linked or not to the implementation of the plan itself (see Véron 2008). In other words, now that politicians have (albeit temporarily) eclipsed market forces as the lords of the financial industry, they have become responsible for its future. It would be irresponsible for them to much delay some hard thinking about what this future should look like.

### Europe's banking integration at the crossroads

One key aspect of Europe's banking industry that will be affected by public policy choices is its degree of cross-border integration. In the past ten years,

cross-border integration has made rapid progress, due to the expansion of Western European banks' activities in Central and Eastern Europe and to a limited number of large cross-border acquisitions such as Santander/Abbey (2004) and UniCredit/HVB (2005). Consider the EU's 15 largest banks (by market capitalization, measured on 30 September 2008). In 2007, eight of them, or more than half, had at least one-third of their total European revenue yielded from outside the home countries, against none ten years earlier. For four of them (Deutsche Bank, ING, Nordea and UniCredit), the proportion was even more than 50 percent: these banks derive less revenue from their home country than from the rest of their European operations.<sup>1</sup>

This striking development, however, remains unequal and the degree of cross-border banking integration varies significantly across Europe. In four of the five largest EU economies (Germany, France, Italy and Spain), foreign-owned banks are generally marginal players, the two only significant exceptions being HVB in Bavaria (part of UniCredit since 2005) and BNL in Italy (part of BNP Paribas since 2006). In the United Kingdom, Santander has built a significant retail operation – and of course, banks from all over the world are present on the wholesale markets – but none of the domestic banks (Barclays, HBOS, HSBC, Lloyds TSB, RBS, Standard Chartered) has expanded much on the continent. Further north, Scandinavia has seen a vivid intra-regional integration, but the presence of non-Scandinavian banks there remains limited. Altogether, Europe's large banks are generally less internationalised than large European companies in other sectors (Véron 2006).

Even within these limits, though, cross-border banking integration appears to have brought significant economic benefit where it has been sufficiently developed to have an impact, most strikingly in Central and Eastern Europe. In these countries, the strong catch-up growth of the past few years has been fuelled not only by foreign direct investment but also by the easily available credit from Western



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<sup>1</sup> Author's calculations based on corporate disclosures. I thank Martin Saldias Zambrana for his highly valuable research assistance in assembling these numbers.

banks which themselves benefited from favourable refinancing conditions (one negative aspect of this credit expansion, however, has been the high share of foreign-denominated lending). Cross-border banking integration has also contributed to a rapid distribution of new financial products and service offerings throughout the EU. On the whole, it is likely to have contributed to a more efficient allocation of capital, thus allowing better access to finance and better returns on investment for companies and households across the EU, even though quantification of such effects remains notoriously difficult (see London Economics 2002).

However, the cross-border integration of the past decade has taken place in a climate marked by low credit spreads and relatively low concern about systemic risk. The public policies which have had most impact during that phase have been those carried out at European level on competition and the internal market. The European Commission has played a powerful role as enabler of cross-border consolidation by ensuring that prudential controls over national banking sectors were not abused for protectionist purposes. Landmark cases have included Santander-Champalimaud in Portugal (1999), takeover bids on Antonveneta and BNL in Italy (2005), and the combination of banking assets held by HVB and UniCredit in Poland (2005–06).

Prudential regulation, meanwhile, has not kept pace with market developments. While many banks were internationalising at a rapid pace, supervision has remained essentially national, governed by national laws and carried out by national authorities. A modicum of coordination has been brought by the creation in 2004 of the Committee of European Banking Supervisors (CEBS) in the framework of the so-called Lamfalussy architecture for financial regulation, but CEBS has a merely advisory role, no binding decision-making powers of its own, and few permanent staff. Even before the credit crisis erupted in the summer of 2007, many voices have expressed concern that the fragmentation of Europe's supervisory framework made it increasingly difficult to fulfil its financial stability aims (see Véron 2007a; Decressin, Faruquee and Fonteyne 2007).<sup>2</sup>

<sup>2</sup> See also Alexandre Lamfalussy's second Pierre Werner lecture delivered at the Central Bank of Luxembourg, 26 October 2004; European Financial Services Round Table "On the Lead Supervisor Model and the Future of Financial Supervision in the EU", June 2005; "Towards Further Consolidation in the Financial Services Industry", European Parliament motion of 8 May 2006; Charlie McCreevy's keynote address at the conference "Challenges for EU Supervisory Arrangements in an Increasingly Global Financial Environment" organised by the European Commission, 26 June 2007.

With the major repricing of risk and widely shared expectation of "reregulatory" initiatives resulting from the financial crisis since August 2007, the equation of cross-border banking integration in Europe is likely to be fundamentally modified. Especially since the brutal degradation of the interbank lending market in September 2008, financial stability concerns have taken centre stage and banks have been brought on an unprecedented scale under the protection of their home country government. In some cases, this has resulted in the immediate unwinding of previous cross-border combinations, as when the government of the Netherlands unexpectedly announced the nationalisation of the Dutch operations of Fortis and Fortis' share of ABN Amro, invoking depositor protection concerns, on 3 October 2008. Similarly, RBS has signalled a downsizing of its business abroad to concentrate on its core UK retail activity (see Larsen and Tucker, 2008). In an era of scarce capital and governments' overwhelming concern of maintaining credit in their domestic economies, it is likely that the short-term trend will be a reduction in the international operations of most European banks compared with the domestic ones. Simply put, support from home-country taxpayers cannot sustainably be used to shore up credit operations in other countries. Granted, cross-border consolidation can also result from the turmoil, as when BNP Paribas acquired most Belgian and Luxembourg operations of Fortis in early October, but under the current circumstances such cases will not compensate the powerful drive towards renationalisation of European banking.

As a result, policymakers have a Gordian knot to cut now. On the one hand, the collapse of trust of early October forced them to take charge of the banking industry and will necessarily result in a reregulation drive. Conducted by national governments, this would tend to refragment the European banking industry along geographical lines, with detrimental economic consequences. On the other hand, existing cross-border banks need a credible regulatory and supervisory framework that respects the interests of their stakeholders in the plurality of countries in which they operate. The earlier belief that banks could live their lives somewhat independently of public oversight, and support in crisis times, has been proven a myth. This humbling lesson applies as much to Europe's cross-border banks as to the US investment banks, which have either disappeared or sought the protection of US authorities by becoming regulated banks. In other terms, the challenge facing policymakers, beyond the short-term fixes announced in October, is to achieve

reregulation without refragmentation of Europe's financial services industry.

### Policy options and the case for EU level authority

How to square this circle has been discussed extensively among EU Member States since the crisis erupted, and even before. However, the discussion has bumped repeatedly on the familiar obstacles to institution-building at European level. In individual countries, either central banks have a mandate to supervise banks, or a separate agency, such as the Financial Services Authority (FSA) in the United Kingdom, carries out the supervisory tasks in liaison with the central bank and government. When a bank or a financial group expands operations to several countries, the approach has traditionally been to introduce closer cooperation between the home-country supervisors and its counterparts in other countries. However, the degree of internationalisation of some European banks, a feature that could only accentuate if cross-border integration does not stop, is difficult to reconcile with any primacy of the home-country supervisor in intergovernmental-style arrangements. This is especially the case where foreign-owned bank have major systemic importance in host countries. For example, Fortis, the largest Belgian bank, is now expected to shortly become part of BNP Paribas. In Finland the market leader is Nordea, headquartered in Sweden, and the number three is Sampo, owned by Danske Bank. In Poland, Pekao is the second-largest bank with a market share approaching 20 percent, higher than its parent UniCredit's market share in Italy. In Romania, the three dominant banks are BCR, BRD and Raiffeisen Romania, respectively controlled by Erste Bank (of Vienna), Société Générale (of Paris) and Raiffeisen (of Vienna).

Having such systemically important local players supervised at group level by a foreign authority accountable to foreign stakeholders creates severe political tension, especially in times of stress. To alleviate it, the European Commission has proposed to create 'supervisory colleges' under the auspices of CEBS, for which an institutional underpinning would be provided by the Capital Requirements Directive (CRD), currently undergoing revision. But these colleges, which will further add to the already dizzying complexity of committees of regulatory authorities in Europe, cannot by themselves solve the underlying tension. Moreover, they will introduce an element of competition among regulatory

structures which will mirror the competition among banks themselves. For example, in Finland Nordea would be supervised by a college led by Sweden's Finansinspektionen, Sampo by another college led by Denmark's Finanstilsynet, and OP-Pohjola by Finland's own supervisor, Rahoitustarkastus. Even admitting close cooperation, the incentives to support national players are such that this *de facto* regulatory competition is likely to result in a 'race to the bottom' as often as in a "race to the top".

Supervisory colleges are thus insufficient to resolve the challenge of consistent and effective supervision of Europe's cross-border financial groups, and their expected reinforcement by the revised CRD, intended as a step forward, is therefore in effect likely to create more problems than it can solve. CEBS, the committee of European banking supervisors, will not be in a position to credibly ensure such consistency and effectiveness, because as an advisory committee to the European Commission it has no binding decision-making authority of its own, and moreover its members are precisely the national supervisors (and central banks) on which it would have to exert oversight. For the same reasons that self-regulation in the private financial industry has been found wanting of late, it is illusory to think that Europe's national supervisory authorities can be effectively disciplined by a committee formed by themselves. A credible supervisory framework for cross-border financial groups will require more than coordination mechanisms among national authorities. It will necessarily entail actual delegation by national authorities of key tasks and responsibilities: such delegation to another national authority accountable to its own national constituency is in many cases politically untenable, but delegation could be done to a jointly governed actor in which each individual country has a stake. In effect, the clear conclusion of the numerous multilateral discussions carried out in the past few months is that no sustainable framework for the supervision of cross-border banks can be defined without corresponding new institutions at supranational level.

If some form of EU-level supervisory authority is necessary to meet today's challenge of reregulation without refragmentation of Europe's banking industry, would it be sufficient? As the events of the past few months have illustrated, government intervention in banking crises is multifaceted and often involves significant commitment of public money. There are currently no legally available instruments

to commit significant financial means for banking rescues at EU level.<sup>3</sup> On 1 October 2008, several prominent economists have together called for the EU to pool financial resources to inject capital into ailing banks,<sup>4</sup> and that same week the French Presidency of the EU has briefly appeared to promote similar ideas. However, one lesson learnt from the frantic days of early October is that even under considerable financial pressure, Member States remain very reluctant to share financial resources in a federal framework beyond what is already provided for within the EU budget and the strictly defined mandates of the European Central Bank and the European Investment Bank. This reluctance is certainly linked to the absence of a tax-raising capacity at EU level, a key feature of the Union's current institutional arrangements. The same reasons make it politically difficult to envisage "*ex-ante*" burden sharing arrangements as have been proposed by experienced observers (Goodhart and Schoenmaker 2006), which would provide ready-made formulas for the sharing of public costs in case of a multinational public rescue.<sup>5</sup>

But while the absence of federal financial arrangements undoubtedly makes the management of banking crises more difficult, it does not fatally undermine the credibility of EU-level banking supervision, assuming an EU-level supervisory authority can be created. This is because having centralized information on financial groups would go a long way towards resolving the coordination problems currently resulting from geographical fragmentation, even in the absence of corresponding centralization of financial resources. Anecdotal evidence suggests that information does not flow easily between national supervisors, especially during crises – even if the official position of authorities is generally to deny the existence of such difficulties, for legitimate face-saving reasons. By contrast, when constrained by necessity, national governments have proved ready to decide quickly to pool financial resources in joint interventions, as has been the case for the rescues of Fortis (by Belgium, Luxembourg and the Netherlands) and Dexia (by Belgium and France) in the last days of September 2008. What has proven most difficult in these two cases has not been the joint commitment of funds, but the subsequent joint

management of a fast-changing situation, eventually leading, in the case of Fortis, to the decision by the Netherlands to nationalise the bank's Dutch assets separately. This experience can certainly not be generalised to all future cross-border banking crises, but it tends to suggest that the absence of *ex-ante* federal budgetary arrangements may not be an insurmountable obstacle to efficient public action, if adequate analysis and recommendations for Member States' decisions were to be provided by an authority at EU level which would be sufficiently accountable to individual countries to be trusted.

### The possible features of a European supervisor

Any debate about establishing new institutions at EU level is often emotionally charged, and easily caricatured as the creation of all-powerful, opaque bureaucratic monsters (see Lodge 2008). A realistic blueprint for a European supervisory authority would need to carefully calibrate its mandate and size in order to limit them as much as is compatible with its envisaged mission, in compliance with the European principle of subsidiarity. It can be suspected that were European leaders to decide to found such a body, it would be under difficult conditions linked to market or economic stress. For this reason, there is a case for a prior debate on what could be the key features of an EU-level supervisory authority, even at a time when the prospect for such a step may appear remote to many observers.

#### Mission

The organisation of financial regulatory and supervisory tasks varies considerably from one Member State to another in the European Union. In some Member States, the central bank is in charge of most or all of the supervisory function, as is the case in France or Italy, while in Germany supervision is divided between the central bank and an independent agency (BaFin). Furthermore, in countries like Britain supervision of individual financial services firms is entirely separated from the central bank: it is one of the missions of the FSA. In a different direction, the Netherlands have implemented the so-called 'Twin Peaks' model, in which conduct-of-business regulation and prudential supervision are carried out by two different agencies even though they apply to the same regulated entities (see Taylor 1995). Countries often reform their arrangements as a consequence of financial crises or financial scan-

<sup>3</sup> Article 119 of the Treaty Establishing the European Community, which has been used to provide assistance to Hungary, cannot be used to intervene in private entities.

<sup>4</sup> Open Letter to European Leaders on Europe's Banking Crisis: A Call to Action, <http://www.voxeu.org/index.php?q=node/1729>.

<sup>5</sup> See Cross-border Banking: Divided We Stand, The Economist, 18 October 2008.

dals, as Britain did with the creation of the FSA in 1997 following the successive failures of BCCI (1991) and Barings (1995). However, it does not seem that any one organisational model is unambiguously superior to the others. For example, in the past decade there has been a trend towards separating supervision from central banking, emulating a model initially pioneered by Scandinavian countries following the crises of the early 1990s. But the credit crisis of 2007–08 has tended to shift the emphasis back to the linkages between the two functions. Spain, a country in which the central bank has extensive authority to supervise the banks, has been seen to have recently avoided some of the mistakes made in neighbouring countries (Tett 2008).

Therefore, there is no single model that would impose itself as the only possible one at European level. However, the already mentioned subsidiarity concern would suggest limiting the European supervisor's mission to the core function of prudential supervision of financial services firms, with no responsibility for other regulatory functions such as protecting investors or ensuring market integrity or the quality of financial disclosures. This does not necessarily mean that such other functions should always remain at national level. For example, there is a strong case for transferring the enforcement function for the implementation of International Financial Reporting Standards (IFRS) by European listed companies to a supranational entity accountable to national securities regulators (Véron 2007b). But there is no need for this function to be combined with that of prudential supervision. On the contrary, trying to bundle several different missions into a "single" European financial regulator would likely be counterproductive.

The same considerations would weigh against entrusting the European Central Bank (ECB) with the role of European supervisor. Beyond the issue of geographical scope (see below), an EU-level central-bank-cum-financial-supervisor would arguably combine more tasks than the current EU institutions allow for: debates about such a powerful institution's autonomy from politicians and democratic accountability, already heated in the case of the ECB, would be further exacerbated, with the risk of endangering the independence of monetary policy. This is accentuated by the fact that supervision often has a closer working relationship with elected governments than monetary policy does, especially when it comes to crisis management in which public funds may be

used. There is no question that supervision should be carried out in close operational relationship with the ECB and other relevant central banks, but the institutions should be distinct.

#### *Sectoral scope*

The importance of an adequate scope of financial regulation has been highlighted by the credit crisis, especially in the United States where the unregulated "shadow banking system" has been found to interact with banks in ways that have been sometimes detrimental to financial stability. This debate is perhaps less acute in Europe, where investment banking operations are generally included in the scope of supervisors together with retail banking. However, European countries vary on whether they bring insurance under the same authority as banking supervision, as has been the general trend of reforms in the past few years. On the one hand, insurance companies have not had the same systemic impact as banks in the developments of the crisis so far; on the other hand, many financial services firms have both banking and insurance activities, some of them of systemic relevance on a pan-European scale (such as ING).

A related question is whether currently unregulated financial market participants, such as hedge funds, should be encompassed. This aspect is likely to be the matter of discussion at international level. The blueprint for a European supervisor could be correspondingly adapted to any enlargement of the sectoral scope of financial regulation overall.

#### *Geographical scope*

The European supervisor should be an EU institution, because only the EU offers a sufficiently strong legal and political framework for such a key public function to be carried out at supranational level. Thus, its authority could extend to the whole EU but not beyond. For example, Swiss banks could in no case be under its jurisdictions, even though bilateral agreements could be envisaged with the Swiss authorities, as currently exist between Switzerland and individual EU Member States, or with the United States.

Whether the supervisor's geographical scope should be less than the entire EU is a matter of political discussion. There is no strong case to limit it to the euro area, because banking integration and monetary integration seem to be two different dynamics. Most cross-border banking groups in the EU combine sig-

nificant operations inside and outside the euro area: Santander, Nordea, UniCredit or Raiffeisen are typical examples. Moreover, the centrality of London, as Europe's financial hub and location of a large part of wholesale operations for many of Europe's largest banks, means that the benefits of pooling supervision at supranational level would be significantly reduced if the United Kingdom were outside the geographical scope. As a consequence, there is a strong case for a scope which would include all EU Member States.

#### *Division of scope with national supervisors*

The subsidiarity principle dictates that a European supervisor should have jurisdiction over only those banks and financial groups that can not adequately be supervised by national authorities acting alone. Under that principle, only large financial firms with significant operations in several countries should be supervised at EU level, leaving the vast majority of Europe's 8,000-odd banks with an unchanged, national supervisory framework. The cut-off between national and EU-level supervision could be defined either by compulsory thresholds – any bank above a given size and a given degree of internationalization measured by key operating parameters such as revenue, employees or assets, say, would be included in the European supervisor's jurisdiction – or on a voluntary basis, supposing that the cost savings resulting from one single supervisory partner would be a sufficient incentive for all relevant groups to submit themselves to EU-level oversight. The second option, voluntary registration, would introduce an element of regulatory competition between the national and European levels, whose possible consequences would need to be carefully weighed. In any event, the number of groups subject to EU-level supervision can be expected to be no more than a few dozen in total, thus preserving a major role for most existing national authorities.

Financial groups supervised at EU level may be subject to a specific legal regime in order to establish a proper basis for their supervision and ensure a sufficiently level playing field. This could take the form of a European banking charter, supported by appropriate EU legislation (Decressin and Cihak 2007).

#### *Functions and organisation*

The core of a European supervisor's role should be an unconstrained ability to collect and analyse infor-

mation from the supervised entities. To have credibility, it should have direct access in principle to supervised firms to obtain information, including possibly by sending inspectors on site within its geographical scope. In practice, however, it should leverage a working relationship with, and delegation to, national supervisors in order to benefit from their advantage of proximity, which can greatly facilitate both access to information and understanding of it. How concretely and exactly this relationship can be organised would be an important operational aspect of setting up a European supervisor.

There is also an important debate required on what tools the European supervisor should have beyond access to supervisory information and the means to analyse it. How far to go in entrusting it with coercive powers on the behaviour of supervised entities, as well as a formal role in crisis management and resolution, would also depend on the legal basis for its establishment, the discussion of which is beyond the scope of this contribution. But even a role limited to the collection and processing of information at EU level would be a substantial addition to the current situation, in which no single public authority can build a complete picture of the European operations of a large, cross-border financial group.

A European supervisor would also have a role to play if, as could be decided as a consequence of the crisis, it is decided to introduce a mechanism of "dynamic provisioning" to allow the assessment of capital adequacy to take into account the effects of multi-year financial cycles. If part of a global supervisory framework, such calculation may need to include a regional as well as a local/national and possibly a global component, in whose determination supervisors could play a role together with other institutions including central banks.

#### *Governance and funding*

As already mentioned, compared with monetary policy, supervision of financial firms is a role that involves closer interaction with governments and especially treasury departments, as crisis management may involve decisions that directly affect individuals and firms as well as the direct use of taxpayers' money – a fact that recent developments of the credit crisis have amply illustrated. Therefore, the governance of a European supervisor should be conducive to the establishment of strong and trustful relationships with national governments, especially

as the prospect of EU-level financial resources for intervention in the banking system remains a remote and unlikely one at this point of time.

This would mean that the European supervisor should be accountable to the European Parliament and Council, but perhaps also build direct accountability towards national constituencies and especially national parliaments, at least as far as countries are directly affected by its decisions.

Similarly, one could imagine direct funding of the supervisor's yearly budget (which should probably remain modest in any case, compared to that of other EU institutions) by Member States. Private-sector funding of supervision, which exists in several EU Member States, could also be envisaged as a complementary or alternative route, with due consideration of the risk of capture of the supervisor by the supervised industry that it may entail.

#### *Location*

Where to headquarter a European supervisor may sound an ancillary and secondary concern, but experience suggests that it could be a significant aspect of the discussion about its establishment. While this decision will depend on the inevitable horse-trading among member state, it should also be made to maximise the effectiveness and/or legitimacy of supervision.

To that end, three possible locations come to the fore: London, where a significant part of European banks' riskiest and most complex activities take place; Brussels, the centre of political power at European level, where the European Parliament in particular holds most of its hearings and where Council committees meet most often; and Frankfurt, seat of the European Central Bank with which a European supervisor would need to establish a close working relationship.

Notwithstanding political considerations, no other place in Europe comes close to these three in terms of suitability to host a European supervisor. The choice among the three is far from obvious and will partly depend on choices on other aspects of the new body's setup.

#### **The political outlook**

The decision to establish a European supervisor for Europe's largest cross-border financial groups, even

with a limited mandate, would be a significant step compared with previous developments of Europe's financial regulatory framework. This is not a decision that policymakers can take lightly. It may also be the case, depending on the legal basis chosen for such a decision (an aspect whose discussion is not included in this paper), that such a decision would require unanimity of EU Member States.

In the past, opposition to such a project has been driven in part by national authorities defending their traditional turf, and by national reluctance to delegate sovereignty, but also by concerns that financial sector oversight was too delicate a matter to be dealt with in the complex context of the European Union, with its multiple institutional constraints. By itself, so the argument goes, an EU institution could not be reactive, efficient and accountable enough to properly perform the supervisory tasks in the short timeframes imposed by the marketplace. This is an important argument which cannot be ignored. However, the obstacle it creates to reform appears less insurmountable since the ECB, by its deft handling of the financial crisis from the early days of August 2007, has proved that an EU institution could be as reactive and decisive as any other in times of stress.

A parallel argument is that EU institutions may by their very nature have a more heavy-handed, prescriptive, rules-based and politicised approach than national ones. However, especially in the current context of reregulation, this argument does not have any strong empirical basis. On the contrary, it could be argued that placing supervision of certain financial groups at EU rather than national level reduces the likelihood of privileged special treatment that could be detrimental to overall financial stability, and taxpayers' interests. This is actually a general feature of institutional regulatory arrangements, as has been described before the eruption of the financial crisis by Adam Posen, in a parallel observation of the American and European experiences: "when US economic policy decisions were left to the state level, they tended to be reactionary, just as they were on civil rights. [...] the more the central body has had authority over economic policy, the greater the liberalizing influence [...]. The alternative to a strong Brussels is not a decentralized free market and minimal government interference. It is greater political capture of economic policymaking and abuse of authority by member states and subnational governments. [...] In fact, the European experience shows that enforcement of market integration, competition



policy, disclosures and transparency are what really brought the economic benefits of European Union – and that enforcement came during the periods when and in areas where the Commission had competence independent of the member states' specific wishes. When Brussels has been strong, it has been liberalizing, at least internally within the European Union, and that has paid off. When the member states have taken away authority from Brussels, the effect has been reactionary horse-trading and back-scratching [...]” (Posen 2007).

A frequently mentioned concern is that any creation of a new financial authority at EU level, however restricted its initial mandate, would automatically lead to “mission creep” and undue expansion of that mandate to an extent that would suffocate and sideline national financial regulation. This is, however, a matter that can be addressed by adequate legal provisions. One could imagine, for example, that the specific description of the mandate of the European supervisor in its articles of association (or other founding document) could be modified only by a supermajority or even unanimity of the member states. The decade-long experience of Member States with the ECB illustrates that, even in cases when the temptation of mission creep may be present – as is seen by some to have been the case, say, with the Target 2 Securities project – there can be enough institutional safeguards for institutional drift to be safely prevented.

A different line of argument against the creation of a European supervisor is that it would not be sufficient to meet its policy aims. This argument runs in two strands: first, that without supranational financial resources the creation of a supranational supervisory instrument would have no material effect; second, that cross-border financial integration is happening at global level and that its challenges cannot be met unless global supervisory institutions are duly empowered. Both points evidently contain an element of truth, but not to the extent that they would justify policy inertia. As previously argued, even without federal financial resources a European supervisor could significantly alter – and improve – the dynamics of decision by providing ‘the necessary services of multilateral coordination and political buffering’ (Pauly 2007) which no existing structure can offer in the present setting, and which can contribute to substantially reduce the eventual price tag to taxpayers by assessing the risks early enough and accelerate decision-making among member states.

On the latter item, it must be noted that even if a few European banks, mainly headquartered in Spain and the United Kingdom, have very significant retail operations overseas, the bulk of cross-border expansion of Europe’s large banks over the past decade or so has occurred inside the EU. More to the point, the EU offers a framework of law and political accountability that has no equivalent at global level. And a European supervisor would be in a much better position than a fragmented collection of national ones to negotiate internationally, be it in international discussions about shared norms (such as the Basel accord on capital adequacy, or IFRS) or in multilateral ones about particular financial groups, those headquartered in Europe with overseas activities as well as those headquartered outside the EU which have developed significant European operations.

### Conclusion

The establishment of a European supervisor for the largest cross-border financial groups in Europe would be a significant step towards enabling the necessary reregulation of the European financial system in the wake of the ongoing crisis, without leading to economically (and politically) harmful financial refragmentation. The deep-running scepticism and resistance to such a project, which are more marked in some member states than others, need to be balanced with the present dangers inherent in the *status quo*.

Would a European supervisor as is advocated in this paper have made a difference, had it been in place from the outset of the current crisis? Certainly not for the likes of Sachsen LB, IKB, Northern Rock or Hypo Real Estate, whose supervisory regime would not have been affected in view of their predominantly domestic activity. However, supranational supervision may have helped react earlier to the developments at Dexia, Fortis, and possibly other banks which have not been through changes as dramatic but have had to face significant upheavals nevertheless. More importantly still, it would have allowed more comprehensive and comparative information of national policymakers in the context of the massive intervention plan decided by European governments in mid-October, whose implementation is permanently at risk of running divergent courses in different countries, to problematic overall effect.

But once again, the main outcome at stake is a mid-term one rather than immediate crisis management.

The persistence and development of pan-European financial groups, in an era of reregulation, will depend crucially on the existence of a credible supervisory framework which cannot be provided in the absence of institution-building at EU level. This is also a matter of global competition. Take other, non-financial sectors: in the automotive industry, often a symbol of economic nationalism but one in which the European market is genuinely integrated, five of the world's top ten firms<sup>6</sup> are headquartered in Europe. By contrast, in the media industry, which has a long history of fragmentation along national lines, Europe is home to only two of the top ten. Will European banks in the future be more like its automakers, or its media companies? The answer to this question will depend largely on decisions made by governments about their supervisory framework.

The challenge in Europe echoes a global debate. Global financial firms have been key agents of the globalisation of the past ten or twenty years. If they retract to a national or regional playground, globalisation may be deprived of one of its key supporting structures. The world has remembered the mistake that was the Smoot-Hawley Tariff Act of 1930, and is unlikely to raise barriers to trade as a knee-jerk reaction to the crisis – but a refragmentation of the global economic landscape may also take other forms than eight decades ago (Bowers 2008). Evidently, policymakers have a duty to focus on the short-term aspects of the financial and economic crisis. But in so doing, they must also keep in mind the long-term consequences.

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<sup>6</sup> Ranked by market capitalisation as of 30 September 2008. Source: Financial Times Global 500 database ([www.ft.com](http://www.ft.com)).