EuroPOLIS

Economic and legal problems of European banking supervision

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Wolfgang Schäuble, the German minister of finance, has told the New York Times: "We can only achieve political union if we have a crisis" (18 November, 2011). He wants to exploit the sovereign debt crisis to confer additional competencies on the European Union and build new European institutions. He started with the temporary bail-out fund EFSF, he then managed to perpetuate it in the shape of the European Stability Mechanism (ESM), and he now pushes for a "Single Supervisory Mechanism" under the roof of the European Central Bank (ECB). After that, he intends to establish a European Rescue and Resolution Mechanism at the ESM. Other mechanisms are likely to follow if he stays in office.

Schäuble argues that if the ESM is to directly finance the recapitalisation of Greek, Spanish and many other euro-zone banks, the systemic euro-zone banks have to be supervised by a common euro-zone authority because the national supervisors would lack the incentive to be strict enough. He regards the Single Supervisory Mechanism as necessary to prevent "moral hazard". He is wrong. The incentive to be strict depends on the price of the bail-out loans. A lender of last resort, according to *Walter Bagehot*, ought to lend at a penalty. If the ESM, instead of subsidising its loans by a large margin, charged a punitive rate of interest (to be paid sometime in the future), the moral hazard problem would be solved, and the national supervisors would have a sufficient incentive to do a good job. In addition, there is no need for

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the ESM recapitalising banks in countries like Spain where the government is perfectly solvent and has access to the capital market. Spain is not Greece.

Another argument in favour of a European supervisory authority asserts that the national supervision of banks creates “a vicious circle” due to “regulatory capture”. According to this story, the banks – especially those in the Southern euro-zone – persuade their supervisors to be lax. In exchange, they promise to buy large amounts of government bonds at low interest rates. This then leads to a vicious circle: when a banking crisis causes a budgetary crisis, the budgetary crisis, i.e., the collapse of government bond prices, feeds back to the banks’ balance sheets, thus aggravating the banking crisis. To interrupt the circle, so the argument, European bank supervision must prevent the regulatory capture. This justification is not convincing either – for a number of reasons.

First, the budgetary problems of most Southern euro-zone governments have not been caused by a need to support their banks. The governments of Greece, Portugal and Italy did not, and did not have to, bail out their banks in the financial market crisis.

Second, regulatory capture by interest groups is not necessarily weaker at the European level. Quite the contrary, by shifting their lobbying activities to the international level, interest groups can escape the attention of the voters, their main rivals in influencing government policies. This may explain why, for example, the study of *S. S. Andersen* and *K. A. Eliasson* (EJPR 1991), has come to the conclusion that “the EC system is now more lobbying oriented than any national European system”. The most spectacular examples are, of course, the Common Agricultural Policy and the highly protectionist “anti-dumping” policy of the Commission and the Council. Moreover, would the ECB Council, with its built-in Franco-mediterranean majority, be less likely to bend the law than the average national authority?

Third, European banking supervision is not necessary to eliminate the feedback or “vicious circle”. If it is true that supervisors in the Southern euro-zone induce their banks to hold excessive amounts of national government debt, this practice could alternatively be stopped by a simple rule limiting the share of domestic government debt in the banks' portfolios. Such a rule has been proposed by *Jens Weidmann* and before him by *Clemens Fuest*.

Let us now turn to *Schäuble's* third justification for the centralisation of bank supervision: the failure of the national regulators and supervisors at the time of the financial market crisis. First of all, they failed to foresee the crisis. But so did the Commission – even though it is responsible for the EU internal market.

Second, once the crisis had broken out, multinational banks posed a problem for national supervisors. But these issues have been handled effectively in bilateral and trilateral cooperation among the national authorities concerned. Would the 27 EU members of the 17 euro-zone members or a majority among them have known better what to do than the two or three authorities concerned? One of the main reasons in favour of subsidiarity is that much of the relevant knowledge is local.

Third, the outbreak of the financial market crisis was not due to a lack of regulatory or supervisory coordination or centralisation in Europe. The crisis was due to two huge errors:

- The banks erroneously thought that their provisions against risk were sufficient.
- The regulators and supervisors erroneously thought that their regulation and supervision were sufficient.

The error was caused by an innovation: the securitization and tranching of mortgages. It was a case of "trial and error" (*Karl Popper*).

Economists rather than *Schäuble,* who is a lawyer, present a fourth justification for European supervision: policies in one country cause "external effects" in other countries. Strictly speaking, these effects are not externalities in the sense of welfare economics but market spillovers. They are due to international market interdependence which is efficient. But did the national supervisory authorities fail to prevent the crisis because they ignored the foreign effects of their actions? I do not think so. Moreover, the internal effects were much larger than the "external effects". There is no international public good here. Thus, the national supervisory authorities had a stronger interest in adequate supervision than each of the foreign authorities or a European authority deciding by simple or qualified majority. It follows that supervisory control should primarily rest with the national supervisory authority. If the latter failed to take the foreign consequences of its actions or non-action into account (which does not seem to have been a problem so far), the logic of the argument would imply that the European supervisory authority ought to be permitted to override a national supervisor *only if* the European authority decided to be stricter than the national one. Thus, the role of the European authority would be confined to internalizing the negative external effect of undue national laxity. (The same argument, by the way, applies to EU competition policy.)

Finally, *Schäuble* and his "*Sachverständigenrat*" (Council of Economic Experts) argue that the Single Supervisory Mechanism is simply a corollary of the internal market in banking and finance. This is not true. The internal market article (Art. 114 TFEU) calls for the "approximation of the provisions laid down by law, regulation or administrative action in the member states which have as their object the establishment and functioning of the internal market". But what is meant by "the internal market"? Art. 114 explicitly refers to Art. 26 TFEU which defines the internal market as "an area without internal frontiers in which the free movement of goods, persons and capital is ensured". However, international differences in financial supervision and regulation are perfectly consistent with "the free movement of ... capital".

Quite apart from this legal point, it is wrong to assume that "a level playing field" is always optimal from an economic point of view. There are important reasons not to impose equal conditions on these markets. As we mentioned, the national authorities tend to be better informed and have better incentives. Moreover, the national banking systems differ and consequently have different needs. Finally, regulatory competition generates peer pressure (yardstick competition) and encourages innovation. Since error is the main problem, it is a welcome feature of decentralised supervision that it helps to diversify regulatory risk.

Decision-making by majority, as in the ECB Council, raises the additional problem that the majority of highly regulated (mostly Southern) euro-zone states impose their regulations on the minority of less regulated member states in order to reduce the competitiveness of the latter. This is the so-called "strategy of raising rivals' cost". Optimal supervision cannot be achieved in this way. Thus, unanimous recommendations by the Basel Committee are superior to majority decisions of the ECB.

There are many more reasons why the ECB Council with whom ultimate responsibility would rest is not suitable for this task:

- There would be conflicts of interest between its monetary mandate to maintain price level stability and its supervisory role.

- Problems of democratic accountability loom large if there is not one simple goal like price level stability but a plethora of conflicting objectives as in banking supervision.

- Art. 127 sect. 6 is not an adequate legal basis for a single supervisory mechanism under the control of the ECB because it merely empowers the EU Council to "confer *specific* tasks upon the European Central Bank *concerning policies* relating to the prudential supervision of credit institutions …". Indeed, section 5 implies that, as a general rule, supervision should be the task of the national authorities: "The ESCB shall contribute to the smooth conduct of *policies pursued by the competent authorities* relating to the prudential supervision of credit institutions …" A participant in the negotiations about Art. 127 TFEU, Dr.

Gunter Baer, has testified that this article was not intended as a legal basis for general financial supervision by the ECB. A specific task is a specific aspect, not a particular group of banks, e.g., systemic banks.

- Financial supervision by the ECB would be incompatible with its independent status because another institution, the European Banking Authority (EBA), would be entitled to interfere with, and override, the decisions of the ECB in several respects. (The Commission's proposal for adapting the EBA Regulation does not solve this problem.) EBA may set technical standards which bind the ECB, and EBA may give direct orders to particular banks if it is of the opinion that the ECB is breaching European law or if the Council of Ministers calls an emergency or if national supervisory authorities disagree about multinational banks. The effect of such overrides is equivalent to EBA requiring the ECB to take these actions.

To conclude, it may be useful to recall the recommendations of the *De Larosière* Report on Financial Supervision in the European Union (no. 171): "While the Group supports an extended role for the ECB in macro-prudential oversight, it does not support *any* role for the ECB for micro-prudential supervision. The main reasons for this are [I quote only three]:

- The ECB is primarily responsible for monetary policy. Adding micro-supervisory duties could impinge on its fundamental mandate;

- in case of crisis, the supervisor will be heavily involved with the providers of financial support (typically Ministries of Finance) given the likelihood that taxpayers' money may be called upon. This could result in political pressure and interference, thereby *jeopardising the ECB's independence;*
  …

- conferring a micro-prudential role on the ECB would be particularly difficult given the fact that a number of ECB/ESCB members have no competence in terms of supervision".

The Council of Ministers is not heeding the advice of the High-Level Group of Experts whom it has appointed to make recommendations on this subject. The march of folly continues.