Banking Supervision Returns to the Forefront

CEPS Commentary

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The unfolding crisis in Europe's financial markets is presenting the EU's new regulatory and supervisory set-up with its first big test, revealing worrying differences in responses to stress, flaws in the enforcement of rules and gaps in the supervisory framework. Although the evidence is limited so far, some clear-cut policy recommendations can be made, which need to be urgently addressed. Concerted action is needed involving monetary policy authorities, policy-makers and supervisors to agree on a set of policy priorities and to prepare a more integrated response to crises. The reputation of Europe's financial market is at stake.

What started as difficulties in the US subprime mortgage market rapidly became a problem primarily affecting the European banking market, and in particular those banks that were heavily dependent on real estate lending, funded by short-term loans. As a result of the fear that some banks may be suffering losses in their exposure in their real estate loan portfolio, interbank lending rates started to rise, and the market for short-term lending dried up altogether, cutting off smaller banks in particular from the necessary funds.

There was a disturbing difference in the reaction on the part of the central banks, essentially the ECB and the Bank of England. Whereas the former rapidly stepped in to bring extra liquidity to the market, the second stayed aside and reacted too late, triggering a much bigger problem, a bank run, something not seen in Western Europe for the last 15 years. This bank run was exacerbated by the UK's deposit guarantee rules, which made use of an optional clause in the EU's 1994 directive, limiting refunds above the first £2000 to 90% of a client's deposits, intended to stimulate 'market discipline'… Hence both the ex-ante and ex-post crisis management procedures need to be much closer aligned in the EU.

A second policy priority is the implementation and enforcement of rules. The new Basel II rules on off-balance sheet items of banks, regulating the exposures to conduits and special investment vehicles (SIVs), were apparently not properly applied. IKB, the German bank that came into trouble in August, had a credit guarantee to a conduit equal to some 40% of its assets. This constitutes not only an apparent violation of the Basel II

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rules, which came into force in January 2007, but also of the EU rules on large exposures. The IKB experience may be indicative of a more general oversight problem with conduits and SIVs of European banks.

The huge delays with transposition of MiFID (Markets in Financial Instruments Directive), which will enter into force on 1 November, indicates that implementation is an acute problem. The Directive also addresses some of the issues revealed in the current market turmoil, such as the need for banks and investment advisers to devise a policy addressing conflicts of interest, to adopt strict internal governance procedures, to introduce 'know your customer' rules and to give clients more detailed information on portfolio transactions. If member states had been more prompt with the implementation process, some problems could have been addressed earlier.

Supervisory cooperation is a third policy priority. Although Europe has made enormous progress in recent years in strengthening cooperation amongst supervisory authorities, this has focused essentially on regulatory matters, and much less on supervisory issues. Further to the Lamfalussy process, supervisors advise the European Commission on the drafting of laws and discuss common approaches in implementation and interpretation, but common rules to respond to ad hoc supervisory problems are missing. On core day-to-day supervisory matters, Europe is still working with differing supervisory tools devised at the national level and on the basis of bilateral cooperation amongst supervisory authorities. Supervisors are wary of sharing information with other non-supervisory authorities, and integrated multilateral oversight is missing. If Europe wants to maintain the reputation of its single financial market, it will need to make a quantum step towards implementing a fully integrated and enforced system of oversight over the financial sector.