

## The Larosière Report on Financial Supervision: More Efforts are Needed...

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As we have been accustomed, the Report delivered to the European Commission by the High Level Group chaired by Jacques de Larosière on financial supervision in the EU is both clear, precise and addresses in detail its mandate. At this juncture, comments will be limited to certain specific aspects rather than attempting an exhaustive analysis.

After reading the Report one is left with a slight feeling of disappointment, not because of the comprehensive analysis of the causes of the crisis or the detailed proposals concerning Regulatory reform (covered in Chapters I and II) but rather through a perception of a lack of ambition in the discussion of the Supervisory architecture both at European and global level (covered in Chapters III and IV).

This lack of ambition should not be attributed to the experts, whose competence is unchallengeable, but derives implicitly from the mandate. Indeed, in ordering the Report, the European Commission seems to have overlooked the eminently political character of the preliminary choices that need to be confronted in order to implement the indispensable reform of the regulatory and supervisory framework of the financial system. These choices concern, among others:

- A. At European level, between the "inter-national" or "supra-national" character of the new architecture and its implications in terms of transfers of sovereignty. The answer opens up significantly different possibilities concerning the articulation of the reform proposals, be it at Eurozone or EU level as well as concerning the representation of either - or both - of these entities on the world stage.
- B. A parallel debate, being carried out this week end by the European Council, on the impact of the crisis on intra European solidarity raises the question of the accelerated admission of new Members into the Eurozone on more flexible criteria, which could, in turn, have far reaching implications on the subject of the Report. Indeed, one should compare the cost of support by the Union of countries experiencing difficulties - each retaining their monetary sovereignty - with the alternative cost of their integration into the Eurozone. It is not forbidden to believe that this latter option might prove more advantageous for all parties concerned. Accelerated integration would be reminiscent of the bold proposal of Chancellor Kohl to recommend parity between the East and West German Mark at the time of reunification; in present circumstances it is precisely boldness that Europe needs. To the expected outcry that such a proposal would generate from orthodox monetarists, one can oppose the following arguments:
  - ✗ Depreciation of the Euro versus the US dollar might be considered positively in these difficult times (cfr. The British Pound).
  - ✗ The economic weight of Eastern European countries is relatively small (in relative terms far less than the weight of the GDR compared to the FRG).
  - ✗ The current benign inflationary climate limits immediate risks, allowing further economic convergence within rather than from outside EMU
  - ✗ That budgetary discipline will be all the more taken into account that the tools of monetary sovereignty have been transferred to the ECB.

- ✘ That such an enlargement might encourage the last recalcitrant Member States to join EMU, giving considerably increased power to the Union on the international political economic and financial scene.

A refusal of Union solidarity, or the imposition of excessively onerous conditions for joining the Eurozone, would carry the risk of a break up of the Union, just at the very time when the single currency could prove itself to be a most efficient tool in the fight against protectionism.

- C. In addition, this political debate should foster renewed impetus towards a greater integration of economic policies within EMU, which has remained so far not much more than a pious hope. Its implementation would have a direct bearing on the efficiency and coherence of the regulatory and supervisory proposals contained in the Report.

The Report leaves the reader with the feeling that the Group was invited to abstain from any proposal that would imply an amendment to the Treaty (which after the difficulties encountered by the Constitutional and Lisbon Treaties may be understandable, though it limits severely the options available). If this were to be the case, then, for transparency's sake, it should have been disclosed.

As things now stand, the Commission (and indirectly, both the Council and the European Parliament) has in hand an unchallengeable "reference document" which broadly discharges "political authorities" from their past responsibilities but which, on the other hand, engage heavily that of the Report's authors with regard to the future.

One of the important lessons to be drawn from the Report is that both national and European political authorities should be put on top of the long list of people who are co-responsible for the crisis (cited in the Conclusion of the recent Interim Report delivered by the Lamfalussy Commission to the Belgian Government). Indeed, if many financial executives contributed directly to the crisis by partaking in questionable – or even reprehensible – actions or behaving with scant regard of ethical principles, it is also true that, by failing to create an appropriate regulatory framework, the legislator facilitated – through this sin of "omission" – the perpetrating of these very same abuses they now deplore.

As was the case at the time of the introduction of the Euro, which led to the implementation of the "Lamfalussy Process", a similar outcome may be anticipated: at the time, several observers, including the undersigned, had pinpointed the complexities and potential deficiencies of the system. However, in the euphoria surrounding the successful introduction of the single currency and in the absence of any overt crisis, the legislator preferred to rely on "voluntary cooperation" between Member States in the fields of cross border regulation and supervision which, as is underlined by the Report, has dismally failed. As anticipated by the "Cassandras", a full blown crisis of historic proportion was needed in order to reconsider the question. Greater political ambition at the time would undoubtedly have helped Regulators and Supervisors to anticipate the current crisis and, possibly to attenuate its impact, even if its origins are partly to blame on external factors.

However, what is new? The Report amounts essentially to an in depth updating of the Lamfalussy Framework without reconsidering the fundamental intergovernmental character of its architecture despite the fact that it has been identified as its main weakness. The intricacies of the suggested procedures augur future operational difficulties in a domain where speed of reaction can prove to be of the essence. In this way, the reforms may contain already the seeds of a future crisis.

This time around, however, witnessing the inefficiencies of the existing structures, it is hard to invoke the type of excuses used in 2002. The degree of systemic risk created by large participants in financial markets, and the fluidity of transmission mechanisms through the financial system have demonstrated, beyond any possible doubt, the interdependence of national financial markets and their inability to manage a crisis situation in isolation.

As far as macro prudential supervision is concerned, the Report proposes an integrated system at Union level under the aegis of a new "European Systemic Risk Council" (ESRC) which seems well suited for the purpose.

A fully integrated micro prudential regulatory/supervisory framework (even if operationally decentralised) seems equally called for, at least as far as the Eurozone is concerned. The proposed "European System of Financial Supervision" (ESFS) should benefit from a structural autonomy comparable to the European System of Central Banks. Non Eurozone Members could join the system on a voluntary basis (and would be required to do so when applying for membership). They would nevertheless be bound by minimum standards negotiated at global level and which should be incorporated into the "Acquis Communautaire". They should

also be subject to individual cooperation protocols negotiated with the ESFS to ensure the compatibility of data collection and the rule book between the ESFS and national Frameworks.

Such an approach is not only necessary to ensure coherence in the application and interpretation of the rules within the Eurozone, but also to promote an efficient representation of the "second largest reserve currency" on the world stage, as per the Report's recommendation n N° 30.

Another area, which bears directly on the architecture of the system and which is only lightly touched upon in the Report (§233...) pertains to the size of entities and the specialisation of activities. The recommendations envisage the creation, of three new "Authorities" covering the Banking, Insurance and Securities sectors, with a possible alternative carve up along prudential and operational supervisory lines. There is, however, no discussion of the advantages that a "legal" separation at company level along business lines might provide in terms of reducing systemic risk compared with potential economic advantages inherent to total freedom. The gravity of the current crisis and the speed with which it has spread should give pause for thought as to whether, in the interests of the common good, the existence of entities of a size and complexity that make them difficult to control, should be tolerated.

The Larosière Report offers some extremely valuable insights on the origins of the crisis and identifies a number of useful suggestions to improve significantly the existing Regulatory framework.

As far as the architecture of supervisory arrangements at all levels, the proposals seem confined to the "politically correct" rather than considering structures that would be deemed the most desirable. This impression is confirmed by the text of § 218 that makes deeper integration of surveillance mechanisms fully dependant on further political integration of the EU.

There can be little doubt, however, that the value of this "High Level Report" would be greatly enhanced if it made explicit that a fundamentally intergovernmental architecture will never be able to deliver an optimal regulatory framework, at least as far as the Eurozone is concerned. It is crucial that the political authorities and citizens be informed on the choices to be confronted so that nobody will be able to take refuge – when the next crisis occurs – behind the unchallengeable authority of the authors of the current Report.

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