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Europe's Post-Enron Response

How EU policymakers are desperately speeding up market integration and supervision—with, once again, the central bankers the losers.

BY KLAUS C. ENGELEN

For Europe's actors in financial markets—particularly for internationally active banks—streamlining of supervision and regulation on the European level cannot occur fast enough. One leading German banker, Rolf E. Breuer, head of Deutsche Bank's supervisory board and president of the Association of German Banks, is calling for a full-fledged pan-European supervisory agency to reduce the complexity of coping with more than 40 European supervisory bodies. Some benefits of speeding up EU legislative procedures are in easy reach. Fast implementation of the new risk-based capital adequacy rules (Basel II) ranks on top of the list.

Frits Bolkestein, European Commissioner in charge of internal markets, set the tone when calling on EU governments to respond to the "quantity and magnitude of the accounting and corporate scandals in the U.S." To his European constituency he sends a note of caution: "Only the very foolish would pretend that recent events in America could not or will not happen here. The issues raised by Enron, WorldCom, Xerox, and others are issues for us all, and issues that we must address urgently. There are not only dangers of complacency by companies and investors but also complacency by governments and regulators."

When calling a meeting of EU finance ministries on July 23, Bolkestein made clear, as a result of the U.S. scandals, that he EU Commission is pushing for five specific actions:

First, to speed up the corporate governance report by a high level group of experts under Professor Jaap Winter that deals with issues such as management renumeration, the role of non-executive directors, and the responsibility of management for the preparation of financial information;

Second, to ensure that International Accounting Standards (IAS) are implemented and enforced effectively and evenly across jurisdictions. "I also want to see IAS and U.S. GAAP converge by 2005 so that there may be full reconciliation between them," says Bolkestein. "This is why, when I was in Washington two months ago, I agreed with Chairman Harvey Pitt of the SEC that we should now begin an intensive and detailed technical dialogue to resolve our differences on accounting standards and trading screens and to bring about convergence or, at the very least, mutual acceptance";

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Third, the EU is looking "even more intensively at the way the audit profession is regulated. The EU Commission will address in particular the use of international standards on auditing (ISA) for all EU audits by 2005, minimum requirements for proper public oversight of the profession at national and possibly EU levels, and other corporate governance issues, including the future role of audit committees in European-listed companies." The Commission will also explore whether a code of ethics should be established at the EU level to underpin professional integrity within the ever-expanding borders;

Fourth, the drive to implement rigorously determined and agreed to risk-based prudential rules will be intensified. At the center of these efforts to improve the long-term health of companies will be the speedy implementation of the risk-based Basel II capital rules, as well as the occupational pension funds directive that requires funds to properly and prudently diversify their investments; and

Fifth, there will be tougher disclosure requirements for all listed companies—in new directives on take-overs, on prospectuses, and on investment services. Warns Bolkestein: "Investors have a right to all the necessary up-to-date and accurate information so as to allow them to make informed choices, not blind guesses. The market increasingly savages those companies that fail this test."

For Bolkestein, getting all member states in one boat on so many issues on internal market matters is at times an impossible mission: Take the new demand by the U.S. authorities to have top managers of European companies listed at U.S. bourses to swear in front of a notary that to the best of their knowledge their latest annual or quarterly company report contains no "untrue statement" nor omits any "material fact." The fact that German Justice Minister Herta Däubler-Gmelin advised the EC Commissioner that the German government would not tolerate this American request puts Bolkestein on the spot. Here is another transatlantic controversy that an EU commissioner has to settle.

Looking at how European stock markets have simply followed the relentless fall of U.S. equity markets in the summer of 2002, there is no question that a lot of savage punishing of listed companies has already occurred on European bourses. "Without proper levels of investor protection," warns Bolkestein, "we risk financial scams such as those we have seen in recent years involving pensions and mortgage mis-selling, pyramid savings schemes, and U.S. stocks that have collapsed in a flash from billions of Euros in terms of capitalization to what is now peanuts."

At the Brussels stage, both the EU Commission as well as the European Parliament want a piece of the action. "Enron is a signal of the need for better accountability at the European level and for adequate supervision," says Crista Randzio-Plath, who chairs the Committee on Economic & Monetary Policy of the European Parliament. Opening a hearing of that committee on July 9, 2002, she gave European financial regulators and central bank supervisors a convenient platform to air their sharply diverging views on how Europe should modernize financial supervision, taking into account recent disasters such as Enron or WorldCom and the new challenges to secure financial market stability.

"As threats to financial stability might also strike Europe, it is time to assess the capability of regulation and supervision to tackle financial risk in its multiple and elusive forms," concludes Ieke van den Burg, the committee's expert on financial markets in a recent paper. Her key points: There are good reasons to be confident, taking into account the track record of European supervisors. However, there is no reason to be complacent.

Financial markets in Europe are going through a period of rapid change. The euro acts as a catalyst on European financial markets. Private and public initiatives are deeply transforming the sector of financial services. Cross-border and cross-sector links are emerging. "In such a transitional period, any system might be less robust if supervision is not able to keep up."

The key point is that neither EU governments and their finance ministers nor regulators and supervisors dare to be caught sleeping while the global financial house is shaking after the global stock market crash, the terrorist attack on America, and the recent U.S. corporate accounting disasters.

NO LACK OF BLUEPRINTS

EU governments—notably its finance ministers—would, of course, reject Bolkestein's accusation of complacency. They would argue that at least two major blueprints—devised in conjunction with the EU Commission—are ready or are being deliberated on the European level. First, the ambitious pan-European "Financial Services Action Plan" of the European Union launched in 1999. "This program of action," argues Bernhard Speyer and Steffen Kern of Deutsche Bank Research in a paper, "is intended to take Europe a decisive step closer to the ultimate goal of a single European market in financial services. The FSAP pursues four strategic goals: the creation of a single European wholesale market, open and secure retail markets, state-of-the-art prudential rules and supervision, and wider conditions for an optimal single financial market. At mid-term, more than half of the 43-point actions have been finalized. However, the decisive part of the work—those politically controversial legal acts essential to the single market in financial services—is still to be completed." In Bolkestein's view: "The single market is the best way to stabilize markets, to absorb shocks, to protect investors, and to ensure that companies have access to the capital they need." He adds: "Much has changed in the last three years, but the issues and measures identified in that plan are perhaps even more relevant today than ever. But this plan is not an 'á la carte' menu from which people can pick and choose. FSAP will be crucial to any effort at EU enlargement, when the Europe of 15 will soon become a Europe of 25 Member States."

The second blueprint is the set of proposals put forward to EU finance and economic ministers at their May 7, 2002, meeting by German Finance Minister Hans Eichel and his British counterpart Gordon Brown to promote clos-

er cooperation between national regulators and supervisors of financial institutions. At the request of Eichel and Brown, various institutions and expert groups at the EU level are currently drafting proposals to explore how much of the new fast-track procedure that was suggested by a Committee of Wise Men on the regulation of securities markets set up in July 2000 under the chair of Alexandre Lamfalussy, the former Belgian central banker, could be extended to the EU banking, insurance, and pension industries and other sectors of financial services. (See Summer 2002 edition of *The International Economy*: "Central Bank Losers.")

As the "Interim Report" of the EU Economic and Financial Committee (EFC) and the conclusions of Denmark's finance minister Thor Pedersen at the last ECOFIN in Brussels on July 12, 2002, with respect to the "Eichel-Brown Initiative" indicate, the work on the new European framework for faster and more flexible legislation is going forward under considerable time constraints.

There also is the uncertainty that Eichel, a key mover of the reform, may lose his job in the forthcoming September 22 national election. If so, a new German government will be in the driver's seat.

Despite this uncertainty, there is still a broad consensus among EU finance ministers on the following:

1. The Lamfalussy Report recommendations for securities markets should be applied to the banking and insurance sector (expansion of fast-track regulation through the committee advising the EU Commission, i.e., comotilogy).
2. The European Council and the European Parliament would focus in the future on adopting framework principles and regulating implementing powers (Level 1 of the Lamfalussy model).
3. Drafting and adopting detailed technical measures should be left to a committee of high-ranking representatives of the EU member states. This committee would be supported in the process by committees composed, like the Committee of European Securities Regulators (CESR), of high-ranking representatives of the national bodies responsible for supervision. Possible synergies between central banks and banking supervisors could be taken into account in the banking sector. Such synergies depend essentially on the national organizational structures in the supervisory sector, i.e., how far EU central banks have responsibilities in banking supervision in their respective countries (Level 2 of the Lamfalussy model).
4. A new "European Stability Forum" should be established as a platform for addressing on a current basis issues relative to the stability of the financial system. This forum should include the participation of central bankers.

At the last EU finance ministers meeting in Brussels, three expert groups were charged to come up with detailed recommendations in three crucial areas of deliberation by the end of September. On the basis of the expected working group proposals, EU finance ministers are set to make the political decisions on the new European framework for regulation and supervision at their meetings throughout the rest of this year.

Berlin's Deputy Finance Minister Caio Koch-Weser is chairing the working group that is looking into the issues of extending the existing comotoilogy process for securities markets to banking and insurance sectors, streamlining responsibilities and building the needed committee architecture. Henk Brouwer, the executive director of the Netherlands central bank (who already delivered two earlier reports on European banking supervision structures to the EFC), chairs the working group that will look into organizing closer cross-country and cross-sector cooperation of supervisors. This way—to the chagrin of some finance ministry officials—a central banker is well positioned to direct the final recommendations on the participation of central bank representatives in Brussels new committee architecture. A third working group under the French official Jean Pierre Jouyet is dealing with the financial stability issues and thus preparing the ground for the EU finance ministers plan to establish a European Stability Forum.

CENTRAL BANKERS PLAY SECOND FIDDLE

There is a central message from EU finance ministers directed to the European Central Bank (ECB) and Europe's individual central banks regarding responsibilities in bank supervision: Only EU governments and EU finance ministers—because they are accountable to democratically elected parliaments—can ultimately be responsible for "policing" financial institutions and financial markets. This is a message that central bankers still don't like to hear. This means that so far, their own blue print has not seen much acceptance among Europe's political decision makers.

As the leading ECB actors in banking supervision made clear at a recent hearing of the European Parliament's Committee on Economic and Monetary Affairs on the implications of the recent corporate disasters on financial supervision, the central bankers want more time for thorough dialogue with experts and market participants. In their view, EU finance ministers and the EU Commission are rushing things through. They plead with the EU Parliament to help them to get more time to make their case. Thus, we have a paradoxical situation: While EU finance ministers and the market participants are pushing for speeding up the reform process, the EU central bankers are telling Brussels and the member states: "Please, don't go so fast." Are the central bankers hoping to get a better deal from EU governments later on?

To most EU central bankers, the Eichel-Brown proposal to establish a new European Stability Forum is adding insult to injury. Edgar Meister, the Bundesbank's board member who chairs the Banking Supervision Committee (BSC), and Tommaso Padoa-Schioppa, member of the ECB Executive Board respon-

sible for banking supervision, object vehemently to the establishment of such a new forum. Both argue that the existing BSC—together with its Frankfurt secretariat—should be the platform to monitor and deliberate financial stability issues in the EU. And Dutch central banker Henk Brouwer laid out the rationale for keeping central banks involved in prudential regulation and supervision at all major levels. Central banks "are in an optimal position to assess any difficulties at an individual bank, the operation of common factors affecting the stability of groups of intermediaries, and the likelihood and potential impact of macro-shocks in domestic and international capital markets. Also, central banks are lenders of last resort and thus play an important role in crisis management."

EUROPE'S MAJOR FINANCIAL INSTITUTIONS ARE BACKING EICHEL AND BROWN

As the "position paper" of the Association of German Banks on the "Eichel-Brown" initiative (presented in Brussels on August 14) indicates, important segments of Europe's financial industry are supporting the new efforts to speed up and streamline EU regulation and supervision. "Those in charge at the political level," says Manfred Weber, Managing Director of the Association of German Banks when presenting the paper in Brussels, "should take a critical look at already existing bodies to determine their necessity or to suggest any sensible modifications of their composition. But also the establishment of new bodies should carefully be examined." The association representing Germany's private sector banks helped support the "Eichel-Brown" initiative by backing Finance Minister Eichel's proposal to establish a cross-sector Federal Financial Supervisory Agency (BAFin). This agency in Bonn and Frankfurt would supervise all major financial sectors under one single roof: banking, securities trading, insurance, and the pensions industry, similar to the Financial Services Agency (FSA) in the United Kingdom "The experiences to date in the securities sector shows quite clearly that any expansion of the comitology procedure must be accompanied by transparent and comprehensive consultation of market participants at an early stage," says Christian Schwirten, the association's expert on EU regulation and supervision. "Market participants can contribute important insights to the consultation process conducted by the comitology committees, as, thanks to their day-to-day operations, it is they who are closest to the issues requiring regulation." Therefore, the association is demanding the establishment of bodies where market participants give advice not only to the securities regulators but also to the banking and insurance regulators. "Furthermore, transparency and full information with regard to the political decision makers in the European Parliament and the Council must be ensured," says Schwirten. "In addition, the Inter-Institutional Monitoring Group's mandate should be extended to cover the whole financial sector to permit a critical and constructive review of the expanded comitology procedure."

For financial institutions, "enhanced co-operation between national supervisors as a step on the way to a European financial services authority" is another important aspect of the reform initiative. This would specifically mean an improved flow of information, more consistent implementation of EU legislation, easier assessment of developments affecting the national supervisory sectors, and a more intensive exchange of views on supervisory best practices (Level 3 of the Lamfalussy model). "The resulting boost to convergence of supervisory practice would help create a level playing field for undertakings operating across national borders," argues Weber.

On the highly contested issue of the supervisory powers of the European Central Bank, Weber is very firm: "Any transfer of supervisory powers to the ECB must be rejected for several reasons." Adds Weber: "In particular, this would cut off the important option of a cross-sector European supervisory agency." And he continues: "In view of the convergence of the banking, insurance, and securities sectors, extending the ECB's supervisory remit only in the area of banking supervision would not be a forward-looking move and would also fly in the face of a noticeable international trend towards no longer giving direct supervisory powers to central banks that set monetary policy independently. ECB responsibility for supervision of the insurance sector is rejected by the political establishment. Conferring supervisory powers upon the ECB could put its independence in monetary policy at risk."

All this will not keep Europe's central banks from using the recent corporate disasters, the stock market crash, and the increasing volatility of financial markets to ask for a crucial role in the new EU supervision and regulatory architecture. In Frankfurt, the seat of the European Central Bank and the once mighty Deutsche Bundesbank, key central bankers are betting on a new Berlin government to help them retrieve some lost ground when the final decisions on the new regulatory and supervision structure are taken by EU finance ministers toward the close of the year.

But a new Finance Minister will face the reality that not only in Germany but also in other EU member states, major parts of the private financial sectors are standing behind the efforts of EU finance ministers to streamline financial regulation and supervision. Deutsche Bank's Bernhard Speyer gives one important reason: "After all, the structure of financial supervision is a competitive factor. Regulations for the financial sector are increasingly the subject of international negotiations. The solutions attained are more and more often not purely technical, but increasingly political in nature. A common European voice would have more weight in international bargaining on supervisory issues. The Europeans' difficulties in the formulation of a uniform position mean that justified European interests are at times not stated clearly enough in international gatherings and are frequently heeded too late." ◆