The March of Folly *Continues*

By Roland Vaubel

The ill-conceived plans for European banking supervision.

Wolfgang Schäuble, the German minister of finance, told the *New York Times* in November, "We can only achieve political union if we have a crisis." 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, the European Financial Stability Facility, he then managed to perpetuate it in the shape of the European Stability Mechanism, and he now pushes for a "Single Supervisory Mechanism" under the roof of the European Central Bank. After that, he intends to establish a European Rescue and Resolution Mechanism at the European Stability Mechanism. Other mechanisms are likely to follow if he stays in office.

Schäuble argues that if the European Stability Mechanism is to directly finance the recapitalization of Greek, Spanish, and many other eurozone banks, the systemic eurozone banks must be supervised by a common eurozone 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 essayist Walter Bagehot, ought to lend at a penalty. If

Roland Vaubel is a professor of economics at the University of Mannheim.

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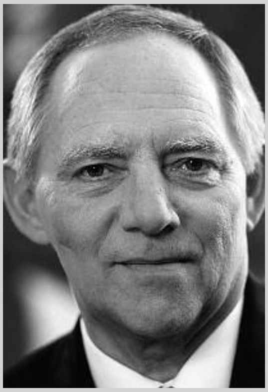
editor@international-economy.com



Wolfgang Schäuble

Never One to Waste a Crisis

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the European Stability Mechanism, instead of subsidizing 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 the European Stability Mechanism recapitalizing banks in countries such as Spain where the government is perfectly solvent and has access to the capital market. Spain is not Greece.

Another argument in favor 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 eurozone—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

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crisis, the budgetary crisis, that is, 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 goes, 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 eurozone 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, a study by S. S. Andersen and K. A. Eliasson (*European Journal of Political Research,* 1991), came 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 eurozone 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 Oxford University Professor Clemens Fuest.

Let us now turn to Schäuble's third justification for the centralization 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 twenty-seven EU members or the seventeen eurozone members or a majority among them have known better what to do than the two or three authorities concerned? One of the main arguments in favor 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 centralization in Europe. The crisis was due to two huge

It may be useful to recall the recommendations of the de Larosière Report.

errors. First, the banks erroneously thought that their provisions against risk were sufficient, and second, the regulators and supervisors erroneously thought that their regulation and supervision were sufficient.

The error was caused by a financial market innovation: the securitization and tranching of mortgages.

Economists, unlike 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 fails 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, Treaty on the Functioning of the European Union) 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"? Article 114 explicitly refers to Article 26 of the Treaty, 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 decentralized 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) eurozone 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 European Central Bank.

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, such as price level stability, but instead a plethora of conflicting objectives as in banking supervision.
- Article 127, section 6 is not an adequate legal basis for a single supervisory mechanism under the control of the European Central Bank 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 Article 127 of the Treaty on the Functioning of the European Union,

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Gunter Baer, former Secretary General of the Bank for International Settlements, has testified that this article was not intended as a legal basis for general financial supervision by the European Central Bank. A specific task is a specific aspect, not a particular group of banks, for example, systemic banks.

■ Financial supervision by the European Central Bank would be incompatible with its independent status because another institution, the European Banking Authority, would be entitled to interfere with, and override, the decisions of the European Central Bank in several respects. (The Commission's proposal for adapting the EBA regulation does not solve this problem.) The European Banking Authority may set technical standards which bind the European Central Bank, and the European Banking Authority may give direct orders to particular banks if it is of the opinion that the European Central Bank 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 the European Banking Authority requiring the European Central Bank to take these actions.

In sum, 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 European Central Bank in macro-prudential oversight, it does not support any role for the European Central Bank for micro-prudential supervision. The main reasons for this are [I quote only three]:

■ The European Central Bank 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 jeopardizing the European Central Bank's independence; and

■ Conferring a micro-prudential role on the European Central Bank 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. ◆