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Europe's Regulatory Chaos

By XAVIER VIVES | FROM THE WALL STREET JOURNAL EUROPE

Europe's financial system has suffered a tremendous shock with the current crisis. EU failings include the lack of a coherent crisis-management framework for dealing with cross-border institutions, the uneven playing field caused by governments racing to insure their national banking systems, and the "Icelandic" scenario: a whole banking system defaulting on foreign investors.

Even more worrisome is that the line of command is not clearly defined in the EU. In a financial crisis, as in war, you need a single authority, not a committee of regulators incapable of taking decisive action. In the euro zone there is one common currency but many national supervisory authorities. So the responsibilities for financial stability remain in national hands.

It is true that the European Central Bank has taken a lead role in providing liquidity to the banking system. But its ability to prevent systemic risks is impaired because it lacks authority, and potentially even the information, on systemically important cross-border groups.

These are some of the shortcomings a panel of experts recently pointed out to the European Commission. Dubbed the "de Larosière" report after the group's chairman, it proposes a system of committees with more authority, and a "European Systemic Risk Council" to be headed by the ECB in charge of macroprudential issues. The group also proposes a "European System of Financial Supervision" consisting of "empowered" committees for banking, insurance and securities supervision. The banking and insurance authorities might later merge.

Cross-border institutions would be supervised by a college of supervisors, led by the supervisor of the bank's home member state. The de Larosière report also suggests mandatory flows of information between national regulatory authorities and the ECB.

The recommendations certainly go in the right direction but don't go far enough. A first question is whether the degree of integration and authority of the committees will be enough to deal with future systemic risks. A second issue is whether the separation of micro -- i.e., individual -- and macro -- i.e., systemic -- supervision is wise. How can the authority in charge of systemic risk do its job properly when it has no supervisory powers over large cross-border groups?

The U.K. experience with a similar tripartite system is not encouraging. The theory was that the Bank of England would take care of financial stability and systemic risk, leaving microprudential and conduct-of-business issues to the Financial Services Authority. In a crisis the U.K. Treasury, the payer of last resort, would have the final say when public money was at stake. This arrangement was intended to minimize potential conflicts between monetary policy and regulatory objectives, and to pool the regulatory expertise needed to assess the converging and complex problems arising in banking, insurance and markets.

In practice, however, there have been problems in information-sharing among the agencies, as well as a tendency to assign blame to the other agency.

An alternative financial regulation model is the Dutch "twin peaks" model. In the Netherlands, the central bank has responsibility for financial stability and prudential issues, including insurance, and a separate

agency takes care of conduct of business issues and investor protection. This ensures economies of scale in information-gathering, a single authority in a crisis and no interference with transparency requirements and investor protection issues. Once it is agreed that the central bank must be the lender of last resort of the financial system, it follows that it must have some supervisory capacity to have a chance to succeed.

Applying this system to the EU level, though, is difficult. Current EU law, for example, gives the ECB no authority over insurance companies. Moreover, some national central banks are not banking supervisors, and the U.K., a key financial player, is not even a member of the euro zone.

In this sense the de Larosière proposal may be a compromise but the lack of integration of macro- and microprudential supervision will remain problematic.

The EU needs a single supervisor for large cross-border groups as well as an explicit burden-sharing procedure in a crisis. Since there is no common fiscal authority in the EU, a prefunded, compulsory European deposit-insurance scheme for cross-border groups seems necessary. This would alleviate the problematic ex post bargaining among member states once a crisis erupts, as well as the Icelandic problem. In short, the EU needs a financial architecture that protects the stability of the system and encourages financial market integration and deepening.

At present, neither of those objectives is guaranteed. The stated will of the EU to lead global financial reform contrasts sharply with the lack of capacity to fix its own house.

Mr. Vives is professor of economics and finance at IESE Business School in Barcelona and author of "Information and Learning in Markets" (Princeton University Press, 2008).

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