

Financial regulation: Is the Channel narrowing?

by Philip Whyte, 27 February 2009*

On February 25th, a Commission-appointed taskforce headed by Jacques de Larosière published its much-awaited report on financial supervision in the EU. By coincidence, a parallel (but less widely reported) event took place the same day on the other side of the Channel: Lord Turner, the chairman of the UK's Financial Services Authority (FSA), gave evidence to a parliamentary committee. What light does Lord Turner's evidence shed on the UK's likely reception of the Larosière report?

London's status as a financial centre has long played an important role in Britain's complex relationship with the EU. Although the UK has been a strong supporter of the single market, it has been suspicious of any moves that might undermine London's position as Europe's pre-eminent financial centre. London's status has partly rested on the UK's 'light touch' regulatory regime. And many in the UK have long worried that the survival of that regime is threatened by the encroachment of EU rules – particularly as countries such as France and Germany, which aspire to 'repatriate' business to Paris and Frankfurt, have never had the City of London's best interests at heart. This explains why the City, the most cosmopolitan economic cluster anywhere in the EU, is relatively Eurosceptic. And it partly explains successive British governments' reticence to EU integration.

However, the financial crisis is transforming some longstanding British assumptions. It is not that the crisis has reduced domestic Euro-scepticism. Domestic opposition to joining the single currency remains as strong as ever. But the crisis has called into question the merits of 'light touch' regulation. Popular feeling against financiers is running high. A backlash is in full swing. Bankers have fallen even lower in the public's esteem than politicians, journalists and estate agents. Given the epic scale of the profits which have been privatised and the losses which have been socialised, the opprobrium financiers are attracting is understandable. All the main political parties are going along with the public mood. But it would be wrong to dismiss the recent furore as politicians pandering to the mob. For the change in British assumptions seems to run deeper: it is intellectual, as well as political.

Take Lord Turner's evidence to the Treasury select committee. What did he say? In essence, he said that the era of light touch regulation was over. He promised a 'revolution' in financial regulation that would include tougher capital rules for banks, and capital and liquidity rules for previously large, unregulated institutions such as hedge funds. Asked about the way in which the FSA had supervised a bank which had to be bailed out in 2008 with taxpayers' money, he said that it "was a competent execution of a philosophy of regulation that was, in retrospect, mistaken". Lord Turner is no populist, so his testimony represents one of the strongest repudiations of the philosophy of light touch regulation to date. It would be wrong to conclude that the British have converted to the French and German view of financial markets. But the intellectual distance across the Channel has narrowed.

What of the British view on pan-European regulatory structures? The government has opposed periodic calls for the establishment of a pan-European regulator. And there is no reason to believe that the financial crisis has made it anymore keen on the idea. It will continue to oppose any

blueprint that smacks of supranationalism. The question is: does the Larosière report propose institutional structures that the UK could accept? It is not yet clear. The Larosière group is not recommending that a single regulator be established. It has recognised that this would be unrealistic, given the absence of political appetite in the UK and some other member-states. So it has proposed building two separate structures: one dealing with traditional micro-prudential supervision (the oversight of individual institutions) and another with macro-prudential issues (risks to the financial system as a whole).

Micro-prudential supervision would build on existing institutional arrangements by establishing a European System of Financial Supervisors. The day-to-day supervision of institutions would be left to national regulators, and international colleges of regulators would continue to oversee cross-border banks. But there would be greater central coordination. The so-called Level 3 committees, which currently try to coordinate national regulatory approaches across the EU, would be given more powers and turned into new authorities for the banking, insurance and securities industries. Macro-prudential supervision would be carried out by a European Systemic Risk Council. This new body would be chaired by the European Central Bank (ECB), but composed of national central banks and regulators. It would collate and analyse information relating to system risk and financial stability.

Could the British government sign up to the institutional architecture proposed by the Larosière report? Although the report does not recommend the establishment of a single, pan-European regulator the British government may still find it difficult to cede new powers to EU bodies. The governing Labour Party is domestically weakened and, with only a year before the next general election, is trailing the opposition Conservative Party by a huge margin in opinion polls. The political context is important because Labour will not want to expose itself to accusations from Eurosceptic Conservatives that it has “given powers away to Brussels”. The Channel may have narrowed, therefore. But it is far from clear that it has done so sufficiently to allow the Larosière report to be implemented. This is a shame, because there may be no other way to reconcile political constraints with the needs of the moment.

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