EUROPE'S SINGLE MARKET FOR FINANCIAL SERVICES: VIEWS BY THE EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

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ABSTRACT

Although the world of banking and finance is becoming more integrated every day, in most aspects the world of financial regulation continues to be narrowly defined by national boundaries. The main players here are still national governments and governmental agencies. And until recently, they tended to follow a policy of shielding their activities from scrutiny by their peers and members of the academic community rather than inviting critical assessments and an exchange of ideas.

The turbulence in international financial markets in the 1980s, and its impact on US banks, gave rise to the notion that academics working in the field of banking and financial regulation might be in a position to make a contribution to the improvement of regulation in the United States, and thus ultimately to the stability of the entire financial sector. This provided the impetus for the creation of the "US Shadow Financial Regulatory Committee". In the meantime, similar shadow committees have been founded in Europe, Japan and Latin America.

The specific problems associated with financial regulation in Europe, as well as the specific features which distinguish the

European Shadow Financial Regulatory Committee (ESFRC) from its counterparts in the US and Japan, derive from the fact that while Europe has already made substantial progress towards economic and political integration, it is still primarily a collection of distinct nation–states with differing institutional set-ups and political and economic traditions. Therefore, any attempt to work towards a European approach to financial regulation must include an effort to promote the development of a European culture of co-operation in this area, and this is precisely what the European Shadow Financial Regulatory Committee seeks to do. In this paper, Harald Benink, chairman of the ESFRC, and Reinhard H. Schmidt, one of the two German members, discuss the origin, the objectives and the functioning of the committee and the thrust of its recommendations.

Keywords: European Shadow Financial Regulatory Committee; Financial services; Single market

* The views expressed in this paper are the authors' personal opinions and do not necessarily represent the views of the European Shadow Financial Regulatory Committee.

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1. INTRODUCTION AND OVERVIEW

Inspired by the example of the US Shadow Financial Regulatory Committee (SFRC), the European Shadow Financial Regulatory Committee (ESFRC), as well as a similar Japanese body, were founded in 1998. The Latin American Shadow Financial Regulatory Committee was founded in 2000, while the Asian Shadow Financial Regulatory Committee was started in 2004. All five Shadow Committees consist of academics and other independent experts. At their regular meetings, they develop recommendations regarding

fundamental issues and approaches, as well as topics of current interest, in the fields of banking and financial market regulation and supervision. Through their work, the committees try to "shadow" the work of the relevant national or, as the case may be, supranational regulatory and supervisory authorities. That is, they observe, examine and critically assess the evolution and implementation of the strategies and policies of the regulatory and supervisory authorities.

The work of the ESFRC is based on the assumption that scrutiny and critical, but constructive comments by independent researchers working in relevant fields can make a positive contribution to the quality of the ongoing discourse in Europe regarding banking and financial regulation, to the quality of regulatory and supervisory policies and practices, and ultimately also to the stability and efficiency of national and supranational financial systems. In this paper, which is a thoroughly updated and revised version of Benink and Schmidt (2000), we first provide background information on the circumstances which led to the creation of the ESFRC and discuss its objectives, composition and structure, and procedures. Then, we give a brief overview of the statements which have been issued so far by the ESFRC. In presenting the structure and the work of the committee, we attempt to demonstrate the presence of an interesting parallel between the ESFRC and its field of inquiry: incentive compatibility is, in our view, every bit as crucial for the smooth functioning of the committee as it is for the effectiveness of financial regulation and supervision. The paper concludes with a brief look at planned future activities of the ESFRC and some remarks on how we view the potential, and the inherent limits, of this attempt by a group of academics and other independent experts from different countries to make a meaningful contribution both to the overall culture of economic policy discourse and to the quality of European financial regulation.

2. BANKING AND FINANCIAL MARKET REGULATION IN EUROPE

Today, there is general agreement that it is necessary to regulate and supervise financial institutions – particularly banks – and

financial markets. As regards the objectives of financial regulation and supervision, the common view is that they are needed to protect the financial system against systemic risks, which are encountered in a very specific, and potentially very threatening, form in the financial sector. The more integrated the European financial landscape becomes, the more important systemic aspects become, and the more important it is to view them from a regional, European perspective and to address the problem of systemic risk at a regional level. In this respect, developing a European approach to financial regulation and supervision is a complement to the equally important task of identifying and addressing potential systemic risks at a global level. A second objective of financial regulation is to protect consumers who are not sufficiently well informed to protect themselves, and who would find it overly costly to obtain the information they would need to safeguard their own interests.[1] There is also widespread agreement as to the necessity of regulatory action in this area. Here, though, there would seem to be less of a need for transnational strategies and solutions than there is in the fields of regulatory activity that deal with systemic risk.

Traditionally, and in particular in Europe, banks and financial markets have also been regulated to promote other objectives. One goal has been to secure the access of national, state and local governments to cheap, flexible and reliable sources of funding; another has been to foster national banking and financial services industries; and regulatory instruments have also been used to shape the development of the non-financial sectors of economies by allocating or withholding credit according to political criteria. Given the nature of these objectives, it is clear why the financial sector has historically been, and in many cases still is, the most strongly regulated part of the entire economy in most countries. And, at least to a certain extent, the desire to further these goals also explains why, despite the adoption of a common currency, the creation of a single market and the trend towards European integration and globalisation, financial regulation is still seen essentially as a national undertaking in Europe.

The strong vested interest of governments in maintaining control over their own national financial sector gives rise to the concern

that in the regulation and supervision of the financial sector, the transnational – or pan-European – dimensions of ensuring the safety and soundness of financial systems may not be receiving the attention they deserve. One might object to this assessment by pointing to the ongoing co-ordination and co-operation at the European level, the results of which are reflected in pertinent EU directives; the co-operation among the members of the Basel Committee of banking regulators and supervisors; and the efforts of the analogous group of capital market regulators and supervisors (IOSCO). But the existence of these supranational forums is not enough to allay doubts about whether a sufficiently pan-European approach is being taken to financial regulation and supervision. After all, these groups are composed of, and in fact also dominated by, representatives of national governments whose thinking can be assumed to reflect those governments' traditional interests.[2]

That being said, there are good reasons not to call for the creation of a new supranational agency, which would be responsible for regulating and supervising the financial industry. One reason for reservations regarding the concentration of authority in such an agency is the fear that it would be plagued by the problems which are typical of big bureaucracies, e.g. that it would in many cases be too far removed from the place at which a specific problem arises to be in a position to act quickly and in an appropriate manner on the basis of reliable first-hand information. Another reason is that concentrating responsibility within a centralised regulatory agency might take too much responsibility away from the national supervisors who would still have a role to play in any centralised system, and thus undermine their commitment to the system's objectives and their willingness to rigorously enforce its standards. Furthermore, the centralization of authority in a field in which national interests are as strong as they are in banking and finance would in all likelihood lead to politically motivated compromises embodying the proverbial "lowest common denominator" and also stifle innovation in the areas of regulation and supervision.[3] Finally, and perhaps most importantly, centralisation implies the significant problem of addressing and enforcing very different national legal systems. Given that there are sound arguments both for and against the centralisation of financial regulation at the European level, the ESFRC has not taken a stand

in favour of institutional concentration or centralisation. And while the European Shadow Committee seeks to provide a central forum for the discussion and critical assessment of regulatory policies and practices, it would be wrong to assume that those who created this unique European initiative see its role as that of a lobby for the idea of institutional centralisation. Instead, the ESFRC takes the present decentralised institutional structure as a given and endeavours to evaluate other forms and means of European and global co-operation and co-ordination and, wherever feasible and necessary, to promote their adoption.

3. THE ORIGIN, COMPOSITION, OBJECTIVES AND PROCEDURES OF THE ESFRC

3.1. Origin and composition

The idea to set up a European Shadow Financial Regulatory Committee was strongly promoted by George Kaufman, one of the initiators and most prominent spokesmen of the US Shadow Financial Regulatory Committee, which was itself modeled on the Shadow Open Market Committee.[4] The US SFRC comprises many US academics who have made important contributions to the literature on financial regulation. The ESFRC follows the model of the US SFRC quite closely. This has proven to be a great advantage, as it has meant that the ESFRC has not had to spend much time on discussions regarding basic objectives and procedures.

The ESFRC was founded at a meeting in Brussels in March 1998. The initial members were selected on the basis of a vaguely defined, but decidedly non-political criterion: a large number of European countries were targeted, and in each country one or two academics were approached who could be assumed to be experts in the field of financial regulation, and would presumably also be interested in taking part in a co-operative international effort over an extended period of time. Currently, the ESFRC has 13 active members from 12 countries.[5] The range of countries, which are represented is not confined to the EU, and it is most certainly not limited to the euro zone. One member is from Switzerland, and one is an American

who, however, studied in the UK and has done research there for many years. Another factor in the selection of members, besides ensuring the representation of a sufficiently broad range of countries, was the idea that each individual member should be in a position to contribute competence in a specific field such as monetary economics, financial economics or derivatives in addition to his or her knowledge of banking regulation and supervision. One member was on the board of a major international bank before becoming a university professor. While the majority of the members are economists, some are legal scholars who specialise in banking and financial market law. Thus, in terms of both the nationalities and the areas of professional specialisation which are represented, the members of the ESFRC are a heterogeneous group. They hold positions at universities, research institutes and think tanks. If members worked in the financial sector or as members of a legislative body or as regulators or supervisors, this would be seen as compromising the independence of the ESFRC, which forms the basis of its credibility.

At least from a European perspective, it appears that the US SFRC advocates a very specific point of view regarding regulatory issues. Its statements very often embody a radically "liberal" position – in the sense of the word as it is generally used outside the US – which implies a deep-seated scepticism concerning government-imposed regulation, and indeed concerning government intervention in the economy in general. Given the way the European Shadow Financial Regulatory Committee came into existence, it is appropriate to ask whether it shares the orientation of its US counterpart, and if it does not, whether its members have some other common "regulatory philosophy". The answer to both parts of this question is clearly "No". Even though many individual ESFRC members have studied or been a (visiting) professor in one of the Anglo-Saxon countries for an extended period of time, and have certainly also been strongly influenced by this experience, the ESFRC has not adopted the fundamental point of view of the US committee. Nor can it be said, as a group, to be advocating a specific approach to regulatory matters. It would appear that the influence of European heterogeneity is stronger than the members' shared familiarity with the relevant US discussions of, and positions on, regulatory and supervisory issues, and this in fact makes the meetings of the group rather interesting. The

heterogeneity of the group, which is an outgrowth of its members' differing national backgrounds, has also shaped the selection of topics on which the ESFRC has so far issued statements, and its influence can even be seen in the statements themselves. Topics on which it would be plainly impossible, or perhaps just very difficult, to reach a consensus are simply not put on the agenda. As will be explained below, this cautious approach has played a constructive role in the work of the ESFRC.

3.2. Objectives

The ESFRC has defined three roles for itself: to observe, and comment critically upon, current regulatory policy and practice; to serve as a bridge between academia and "the real world"; and to provide a European forum for the discussion of regulatory and supervisory issues. The first of these three functions is the most important one. This "shadow function" does not imply an adversarial attitude, but it does oblige the ESFRC to maintain a certain distance between itself and the agencies whose activities it seeks to evaluate. However, while it is essential to maintain the critical distance required for objectivity, the committee must at the same time make a sufficient effort to appreciate the problems which must be addressed by those who make regulatory and supervisory policy, and the constraints faced by financial regulators at the level of policy implementation. Under no circumstances should the committee engage in gratuitous or glib criticism of regulators or adopt a patronizing attitude towards them.

At least in comparison to the situation in the United States, the exchange of information and ideas in Europe between practitioners in the field of financial regulation and supervision and researchers in relevant fields was very limited in scope until quite recently. At the same time, the financial sector and regulatory challenges and practices have changed dramatically, as have the views of academics on regulatory and supervisory issues. The turbulence and crises that have been experienced in the financial sectors of many countries since the beginning of the 1980s[6] strongly suggest that a solid bridge should be built between theory and practice. There would seem to be sufficient ground for assuming that conventional regulatory

approaches are no longer suitable for meeting the challenges posed by today's financial markets. The old capital adequacy rules of the Basel Committee, and also the new proposal for their revision, are good examples of this point.[7] An exchange of ideas between academics and practitioners can help to identify regulatory problems that call for innovative solutions and highlight effective ways of addressing them. What does this imply for the tasks which the ESFRC has set for itself?

There are, of course, many academics who prefer to remain in their ivory towers instead of making the results of recent academic research – which is often quite sophisticated in terms of the theories and methodologies it employs – accessible to politicians and practitioners. This usually involves "advertising" the importance and relevance of these results, and thus the possibility that they will be criticised as erroneous, irrelevant or impossible to apply in practice. However, the ESFRC feels that its job is to do precisely this, i.e. to attempt to derive strategies for practical action from academic theories and at the same time to test those theories with respect to their relevance and practicability.

Issuing statements aimed at politicians, policymakers and practitioners with the expectation that they will be taken seriously is indeed a way of testing the theories which underlie the statements. Although a given statement might be well founded from a purely academic point of view, its authors will be forced to conclude that it was not as sound as they thought it was if it turns out that those to whom it was primarily addressed, i.e. the relevant group of practitioners, reject it as inappropriate or useless. A consistently negative reaction to the statements of a shadow committee would not only undermine the credibility of this committee, but would also make the relevant group of policymakers generally less willing to accept advice from the academic community. The ESFRC is aware of how important it is to avoid this outcome. This it why it endeavours to take the problems faced by practitioners seriously. And if it is clear to them that the committee understands their problems and realises how difficult it is to solve these problems in the real world, then this means that the first section of the bridge between academics and practitioners has already been built. Important insights produced by

advances in economic theory such as the recognition that explicit and implicit guarantees for financial institutions serve to increase risk, or the insight that adherence to the "principle" that some banks are too big to fail has adverse consequences,[8] will only be accepted – and will only begin to shape regulatory policy and practice – if a serious effort is made to show how they can be implemented in the real world.

3.3. Procedures

The ESFRC meets on two weekends per year (not including the joint annual meeting with the other Shadow Financial Regulatory Committees), and its meetings are held in various cities in Europe. The immediate objective is to prepare a statement on a topic selected at an earlier meeting. Before the group convenes, one or two members will have prepared a draft statement. After a short general discussion of the subject of the planned statement, the draft is then discussed – "pulled to pieces" would be a more accurate way of putting it – for almost an entire day, and then it is usually rewritten completely. On Monday morning, the new draft is presented to the group, discussed again and put into its final form, after which it is presented at a press conference which will have been arranged well in advance.[9] This procedure is informal, but nevertheless very strict. It entails an unusual challenge for a group of university professors, as they are not normally subject to the pressure of having to meet an absolutely firm deadline and nonetheless produce something which is good enough to present to an audience which is also thoroughly familiar with the subject matter. In working towards this goal, the opinions of a dozen strong-willed people from very different backgrounds have to be accommodated. Given the problems this invariably creates, achieving a consensus is by no means easy. Thus, we find it particularly gratifying that so far it has always been possible to arrive at a position that, while it clearly represents a compromise between the group members, is not simply the "lowest common denominator".

The next step is to disseminate the statement. The ultimate objective is to attract the attention of the European regulatory community. A crucial channel of dissemination is the financial press, represented

by journalists working for leading financial newspapers.[10] Thus, it is essential to ensure that the statements are not dull, i.e. that they are not so diplomatic and well balanced that they do not really say anything that is worth reporting. On the other hand, the statements must be more than just a collection of provocative, "flashy" pronouncements, because, while the immediate goal is to attract journalists to the press conferences, the ultimate goal is, of course, to get the committee's message across to the members of the regulatory community. And this means that they must take that message seriously, which in turn means that the statements must be well conceived and present a well-founded case using sound arguments. However, if the statements simply said what the regulators believed anyway, they would probably regard them as sound and well reasoned, but not consider them very interesting.

As we have seen, the mode of dissemination is part of the incentive system that has been created for the committee, and the goal of this system is to ensure that the ESFRC issues statements which not only present sound arguments based on accurate information, but are also interesting and relevant to the practical work of regulators in the various European countries. As a result, the European Shadow Financial Regulatory Committee must seek to meet various criteria when drafting its statements, which invariably involves achieving a balance among differing objectives. The give-and-take involved in this process makes its meetings extremely stimulating, and this in turn appears to provide a strong incentive for the members to participate in the meetings.

The second channel of dissemination consists of e-mail messages by which the statements are sent directly to politicians, regulators and regulatory authorities, and to fellow academics.[11] Needless to say, use of the procedure we have adopted for the production and dissemination of our statements cannot guarantee that the positions taken in them will be correct. However, the built-in system of incentives and checks and balances ensures that all views submitted for the group's consideration are subjected to critical scrutiny, and this in turn makes it highly improbable that an erroneous position will be adopted in an uncritical manner and promulgated "in the name of academic wisdom".

To date, four joint international meetings with subgroups of members from the US, Japanese and Latin American Shadow Financial Regulatory Committees have taken place. The statement which resulted from the first joint meeting in New York in June 1999 was one of the first comments on the new capital adequacy framework which the Basel Committee had issued only days before.[12]

4. THE STATEMENTS OF THE ESFRC

Since its founding meeting in Brussels in March 1998, the ESFRC has produced, issued and disseminated fifteen statements. All statements are similar in terms of their length and style. They are no more than six pages long and are written in a style which avoids economic and regulatory jargon as far as possible so that they can be understood by most educated readers. In the following, the fifteen statements are briefly summarised and certain common themes identified.

4.1. Dealing with problem banks in Europe[13]

The first statement seeks to identify ways in which regulation and supervision can take preventive action to help ensure that a bank does not eventually find itself in a situation in which its entire capital is absorbed by losses and it becomes technically insolvent. As things currently stand, the relevant authorities of the country in which a problem bank is domiciled select one of the following two forms of intervention. Either the bank is saved by a capital injection, which typically comes from the ministry of finance, or from other banks which are pressured to undertake the rescue operation, or it is simply closed by the supervisory agency. Even though in almost all cases the closing of a bank does not mean that its depositors will lose their money (a considerable portion of bank deposits are now formally or informally insured in all European countries), and even though the failure of a single institution will not necessarily endanger the stability of the entire banking system, it will lead to social losses, i.e. losses which affect not only the owners of the failed bank. Interventions typically come too late, and when they are undertaken they are usually not sufficiently well structured. Moreover, if a bank is

already in serious difficulties, all of the available intervention options will necessarily be heavy-handed. This is the main reason why there are so many attempts to avoid intervention altogether—or to delay taking appropriate action. In a nutshell, the lack of a differentiated set of instruments that can be employed selectively – and in time to keep banks from becoming distressed in the first place – leads to regulatory forbearance and bail-outs.

The solution recommended by the ESFRC is an approach which it calls "structured early intervention and restructuring". It entails the definition of a series of trigger points for the capital ratio – and certain other operational indicators of an emerging problem situation at an individual bank – and of specific responses in case these trigger points are reached. If the capital ratio falls to a level defined as a trigger point, the supervisory authority has the strict, e.g. legally stipulated, obligation to take action according to the pre-specified list of measures. These measures serve to restore bank solvency. If the bank's situation continues to deteriorate in spite of the early intervention, more rigorous measures have to be taken. Ultimately, a point may be reached at which the supervisors must either restructure or close the bank.

Creation of a strict obligation to act – whether it be legally stipulated or based on some other form of commitment – which causes the supervisors to intervene in certain well-defined cases in specific, but differentiated ways, would have several advantages. Firstly, it would lead to certainty for all concerned regarding the timing of intervention, i.e. an early response by the supervisors would be assured. Secondly, it would reduce the opportunities, and the incentives, of the owners and managers of troubled banks to take overly risky positions in order to "gamble for resurrection" or to speculate that their banks will ultimately be bailed out. Thirdly, it would reduce the incentives for banks to take the kinds of imprudent actions that are likely to get them into trouble in the first place.

The fourth advantage is that it would make a big difference in terms of combating the practice of regulatory and supervisory forbearance, which has been frequently observed in recent years and which too often aggravates the problems. The strict obligation for

the supervisors to take action would mitigate the time-inconsistency problem that plagues supervisory practice. This inconsistency is not a consequence of laxity or incompetence or of moral hazard behaviour on the part of bank supervisors. Rather, it is a "rational" consequence of the fact that, in a crisis situation, the imposition of sanctions that they have said they will implement if a crisis materialises, is simply not an attractive prospect for supervisors. Finally, if regulators and supervisors had an array of "softer" instruments in addition to the authority to close a bank which they could, and indeed were obliged to, use, it would also increase their willingness to take the appropriate form of action in a given situation.

4.2. EMU, the ECB and financial supervision[14]

The topic of the second statement is the institutional structure of banking supervision in Europe. The present structure is an outgrowth of the Single European Act of 1986 and the 1989 second banking co-ordination directive. This directive combines a minimum degree of harmonisation in the field of banking regulation with the principles of mutual recognition and home country control. All EU member states have in the meantime implemented the directive, with the consequence that the relevant regulation is largely similar in all member states and banking supervision can, and indeed must, be restricted to that which is exercised by the authorities of the respective home country.

The European Shadow Committee is well aware of the advantages of this approach to banking regulation and supervision. But it feels that the decentralized approach should be complemented by a certain degree of co-ordination at the European level, and that there must be an institutional basis for this co-ordination. Therefore, the ESFRC recommends the creation of a "European Observatory of Systemic Risk", which might or might not be a part of the ECB. An important function of this observatory would be to improve the flow of information which might be relevant to the task of assessing systemic risk within the emerging pan-European financial system and specifically between the various countries and their national regulatory and supervisory authorities, and, by so doing, to help the national regulators and supervisors carry out their functions more effectively.

The EU principle of home country control is based on the assumption that the various national bank regulators and supervisors have the same legal standing. This assumption of formal equality suggests that the national authorities are also equal in terms of their professional expertise and ability to perform their assigned functions and with respect to the degree of political independence which they enjoy. In fact, however, the various national agencies are probably not all equally competent, or equally independent. Evidence drawn from specific cases in various countries shows that supervisors in the EU are not all equally well prepared to take appropriate action in a national banking crisis, and that they are not all equally free from the kind of political pressure that can limit the scope for such action. The ESFRC feels that the mere existence of a European Observatory of Systemic Risk with the right to request relevant information from the national supervisory authorities would help to make the conditions under which they operate more uniform, and thereby strengthen these agencies' independence and powers and contribute to a harmonisation of the practice of banking supervision in Europe.

In this context, the ESFRC also recommends that national practices in relation to lender-of-last-resort operations should be harmonised within the euro zone and that responsibilities in this area should be clearly allocated between the ECB and the national central banks.

4.3. Towards safer derivatives markets[15]

Since the beginning of the 1980s, there has been a spectacular increase in derivatives trading. The extremely rapid growth in the markets for derivatives contracts has raised concerns regarding their potential to undermine the stability of financial systems. The ESFRC's third statement addresses this issue, and deals primarily with the risk in over-the counter (OTC) markets for derivatives.

OTC derivatives are not standardised with respect to volumes, currency denominations or terms to maturity. Therefore, they are not traded on exchanges, which means that trading in these instruments is not regulated and supervised and transactions in OTC derivatives are not protected by the involvement of clearing houses, which would

eliminate most of the transaction and counterparty risk. This is why the clearing and settlement of OTC transactions very often leads to problems. For instance, if a clearing house is not used, there is the danger that one bank might believe that it has hedged a risky position through a derivative contract with another bank, only to find that, due to the latter's default, the position is not hedged. If they involve large amounts, cases like this can lead to a systemic crisis.

The European Shadow Committee drafted a series of recommendations which would make the OTC derivatives market safer. One of theses recommendations concerns the capital requirements which banks have to meet with respect to derivatives. The ESFRC feels that the capital requirements for positions in OTC derivatives should be higher than for exchange-traded derivatives. This would have two advantages. One advantage lies in the fact that higher capital requirements would correctly reflect the fact that the risks involved – in particular, clearing and settlement risk – are indeed higher. The ESFRC sees a second, and possibly even greater, advantage in the fact that higher capital requirements for OTC derivatives would presumably encourage financial institutions to switch from OTC to exchange-traded derivatives wherever possible.

4.4. Improving the Basel Committee's new capital adequacy framework[16]

The fourth statement issued by the ESFRC was drafted and published as a joint statement by members of the Shadow Committees of the US, Japan and Europe. This statement was the first formal response to the draft version of a "new capital adequacy framework" which the Basel Committee on Banking Supervision (Basel Committee on Banking Supervision, 2001) had issued only a few days earlier to initiate a discussion of its position and elicit comments from members of the regulatory community, academics and other knowledgeable observers of the global banking scene.[17] The fourth statement deals with the following question: What is the best fundamental approach to the problem of defining capital adequacy and determining capital requirements for banks? And the fact that this issue was addressed only days after the publication of the Basel Committee's new draft framework meant that, in this case, the

fulfilment of one of the tasks which the ESFRC had defined for itself – namely that of observing, and commenting critically upon, the work of international regulatory authorities – was greatly assisted.

At the heart of the new proposal put forth by the Basel Committee is a revision of the risk weights for individual asset classes that are employed in the determination of the credit-risk capital requirement for an internationally active bank.[18] The other side of the "equation", i.e. the definition of what constitutes the capital of a bank and the percentage of the risk weighted assets which has to be available in the form of capital, is not specifically modified by the new Basel proposal, and is therefore also not discussed at great length in the statement of the Shadow Committees.

As is by now well known, the first version of the Basel Committee's new capital adequacy framework outlined an innovative approach that would permit borrowers' external credit ratings, as provided by rating agencies, and the internal ratings established by "sophisticated banks" – the term used in the Basel proposal – to be employed to determine the risk weights for loans.

It appears to the Shadow Committees that, compared with the current system which is based on an arbitrary set of risk classes,[19] the approach set forth in the new proposal represents a step in the right direction. However, it fails to eliminate the central drawback of the current method of determining a bank's capital requirement, as the new proposal maintains the present system's "crude additive approach to measuring the risk of a portfolio", as it is characterised by the Basel Committee itself. This "additive approach" is extremely "crude", not only because of the concept of portfolio risk on which it is based, but also because it is an unsuitable means of achieving what capital regulation is intended to accomplish. The risk in a portfolio of any kind – including one consisting of loans – is not simply equal to the sum of the risks associated with the individual assets in the portfolio. And while a more sophisticated, differentiated approach is clearly needed, it would be highly problematic to permit each individual bank to evaluate the level of risk in its portfolio completely on its own. This might create strong incentives for the banks to misrepresent risk-related information and it would also place an

excessive burden on bank supervisors, who would, in effect, be given the task of monitoring the quality of the institutions' internal risk assessment systems.

Given these problems, the statement issued by the three Shadow Committees contains an innovative – and, in our view, very useful – alternative proposal which is based to an important extent on earlier academic contributions by Charles Calomiris, a member of the US Shadow Committee. This proposal outlines an approach that enables the information which market participants have, and the financial self-interest of well-informed market participants, to be utilised for the purposes of banking regulation.

Of the various economic agents that operate in financial markets, professional investors can be assumed to have the best information. If these market participants lend money to a bank in the form of subordinated debt which cannot be called in whenever the lender wants to get its money back, and must be rolled over or replaced with new lendings at short intervals, then the interest spread on the subordinated debt can be taken as an indicator of the solvency of the bank as it is assessed by the market. The spread is a risk premium and thus also an indicator of risk. The implication of this insight for solvency regulation is straightforward. Instead of defining an upper limit for subordinated debt as a component of the so-called tier-two capital, which is what the current Basel Accord does, the capital adequacy framework should require international banks and banks domiciled in countries with an active interbank market to have a certain minimum amount of subordinated debt at all times. Imposition of such a requirement would create an efficient incentive mechanism. The providers of subordinated debt would have strong incentives to reveal their information on the borrowing bank by requiring a spread which adequately reflects the riskness of its assets; and they would be motivated to monitor the solvency of the borrower closely so as to safeguard their funds and ensure that they would be well informed when the time came to renew the loan. The borrowers would have an equally strong incentive to minimise the spread or risk premium on the subordinated debt, which they would be required to take on. They could accomplish this by ensuring that they had a sufficient amount of equity, which is, of course, exactly

what bank regulators and supervisors want them to do in any case. But this is not the only advantage of the proposed arrangement. Bank supervisors could also easily observe the spread on the subordinated debt of a given bank, which lenders would require. And they would interpret an increase in the spread or risk premium – or, in extreme cases, the observed inability of a bank to obtain subordinated loans at any price – as a signal that something had happened which deserves their attention. Alternatively, bank supervisors could define events of this type as triggers for on-site inspections or other measures from the arsenal of early and structured intervention discussed above. If supervision made use of this opportunity, its interventions could be relatively limited in scope because they would be undertaken quickly and in a timely fashion.

4.5. A new role for deposit insurance in Europe[20]

The fifth statement addresses the question of whether the deposit insurance systems that are in place in Europe need to be modified to take account of the fact that the European financial system is currently undergoing a process of rapid integration. The changes in the financial system that have focused attention on this issue arise from increased competition and a wave of restructuring in national financial sectors, and they are likely to lead to a higher incidence of bank insolvencies in the coming years. As a result, the ESFRC concludes that changes to deposit insurance systems are indeed required and specifies the kinds of action that should be taken. The European Shadow Committee recommends that the EU's 1994 Deposit Guarantee Directive be clarified and modified as follows:

(1) Financial institutions should be permitted to advertise that their depositors' funds are insured under certain conditions and up to a certain, i.e. precisely defined, limit. As the insurance coverage differs between countries, the increased transparency created by this change to the regulations would seem desirable.
(2) In the case of a bank failure, the guarantee institutions should reimburse eligible depositors immediately, and not wait for three months to do so. This change would reduce the likelihood of bank runs.

(3) It should be made very clear to depositors that there is no difference between the declared scope of deposit guarantees and the effective extent of such guarantees; in other words, steps should be taken to ensure that the relevant authorities never exceed the formal guarantee limits. Unless this commitment is binding, it will be impossible for the kind of market pressure to develop which is needed to discipline banks and give them an incentive to limit their risk-taking.
(4) Risk-dependent insurance premiums should be used. These premiums should be set on the basis of observable market indicators of solvency risk such as those proposed in the fourth statement, and payments into the insurance fund should be made before and not after a case of insolvency occurs.

All of these proposals are motivated by the concern that deposit guarantee systems, which the ESFRC regards as politically and economically unavoidable, may have strong negative incentive effects, and by the conviction that such systems need not have such effects if they are properly designed. The above recommendations are furthermore based on the insight that in the real world the alternative to having a formal deposit guarantee system in place is not simply doing without deposit guarantees, but rather employing informal or implicit guarantees. Given this situation, the proposals of the ESFRC would serve two purposes. For one thing, they would make it both possible and desirable for national authorities to liquidate insolvent banks instead of bailing them out, which is what supervisors have often done in the past; for another, they would make it unattractive for banks to take on an excessive amount of risk.

4.6. Banking mergers and acquisitions in Europe[21]

The sixth statement of the ESFRC deals with mergers and acquisitions involving financial institutions from different European countries. It proceeds from the plausible assumption that in the future there will be many more cross-border M&A transactions involving European banks, and acknowledges the fact that at present national regulations and policies pose specific obstacles to cross-border mergers and acquisitions in the banking industry. Moreover, policies in this area differ between countries, and they are not

sufficiently transparent. Thus, cross-border mergers and acquisitions in the banking sector are subject to a specific "political" risk, i.e. the risk that relevant national policies and attitudes will prevent these capital transactions between countries from being carried out, and thus make it impossible to realise the efficiency gains which can be produced by such transactions.

The ESFRC is of the opinion that the relevant national authorities should continue to have, and exercise, the right to express their opinion on aspects of a planned or proposed cross-border merger or acquisition which have to do with solvency and governance. However, any discretionary action which would prevent an envisaged cross-border M&A transaction from taking place should be strictly limited to cases in which there are concerns relating to antitrust issues or fears regarding the safety and soundness of the respective financial system. This limitation of the scope for action on the part of national authorities would increase transparency and make it easier for European financial institutions to engage in long-term planning, and to conclude the agreements needed to achieve strategic goals in the European market. At the same time, the ESFRC recommends that the European Commission take steps to harmonise and liberalise the various national policies and regulations concerning cross-border mergers and acquisitions.

4.7. Internal ratings, capital standards and subordinated debt[22]

In its seventh statement, the ESFRC returns to the new capital adequacy framework proposed by the Basel Committee in 1999 and to the joint statement of the three Shadow Committees discussed above, which explains how the introduction of a subordinated debt requirement could facilitate capital regulation.

One key feature of the original proposal was that it attached great importance to external ratings in the determination of risk weights. From a European perspective, this proposal must necessarily be regarded as problematic. External ratings are not widely used in Europe, and, as a result, such an approach would create an inappropriate competitive disadvantage for European banks. This criticism has in the meantime been expressed very clearly by many

participants in the ongoing discussion of options for the reform of the capital adequacy framework. The Basel Committee has responded to these concerns by assigning a larger role to internal ratings. In its statement, the ESFRC welcomes this shift of emphasis because internal ratings may at least offer some scope to incorporate portfolio aspects in the measurement of banks' risk exposure, and because their use is much more compatible with the economic logic of banking than the employment of external ratings. But the ESFRC also reiterates its concern that the use of internal ratings as a basis for determining how much capital a bank must have might encourage banks to manipulate and misrepresent information, and that bank supervisors would scarcely be in a position to prevent them from doing so[23]. These problems cannot be eliminated by simply requiring banks to subject their internal rating systems to the scrutiny of bank supervisors. What is needed instead is an incentive mechanism which would induce banks to reveal their information to the supervisors in a truthful manner.

One such mechanism is the requirement that banks have a minimum proportion of "credibly uninsured liabilities", i.e. subordinated debt, which is recommended in statement No. (4) and discussed above. The use of internal ratings in conjunction with a requirement mandating a certain level of subordinated debt is a particularly attractive option, and it is therefore strongly endorsed by the ESFRC. Despite the fact that a compulsory subordinated debt scheme would give rise to certain problems in the case of small banks, such a scheme is an essential part of any capital standard based on internal ratings. Indeed, it is a necessary element of a standard of this type, for without such a scheme a standard based on internal ratings is not likely to work, and without an internal ratings standard, capital requirements are not likely to serve their overall purpose of improving the safety and soundness of the banking system.

4.8. Towards a single market in European securities trading[24]

Over the past decade, the development of the European securities exchanges has been a remarkable success story. Owing directly to the force of cross-border competition, European exchanges have implemented major reforms in trading systems and internal

governance which have significantly improved their efficiency and reduced investor trading costs. Yet the exchanges are now facing enormous pressure from the major international trading houses to cut costs much further by consolidating trading and settlement operations on far fewer platforms. This has led to a wave of dramatic merger and alliance proposals which augur a fundamental restructuring of the competitive landscape in trading operations and the re-allocation of market regulation authority across EU national securities commissions.

The European Commission is currently conducting a major review of the 1993 Investment Services Directive (ISD) as part of its "financial services action plan", with the aim of proposing wide-ranging reforms. In its most recent statement the ESFRC urges the European Commission to address a key weakness of the ISD – the so-called "regulated markets" concept – which, as things stand, may be used by national authorities as a protectionist weapon.

Article 15.4 of the ISD provides for a "single passport" for EU trading systems, allowing a system authorised by the competent authority in one national jurisdiction to provide remote services in all the others. This single passport is a manifestation of the concepts of "mutual recognition" and "home country control", utilised in a number of single market programme directives to facilitate market integration without the need for prior harmonization of laws and regulations across the Union. Home country control provides a major stimulus to market integration by negating the natural protectionist tendencies of host state authorities, which may attempt to hinder the operations of foreign competitors when they threaten the franchises of domestic incumbents.

The ISD single passport, however, only applies to so-called "regulated markets". The definition of such markets was the source of enormous controversy within the EU Council of Ministers during the original ISD negotiations, which began in 1988. If an exchange or trading system was not legally a "regulated market", then it was obliged to seek explicit authorisation to operate in each and every national jurisdiction in which it wished to provide services, even if only by remote cross-border electronic link. Local protectionism was

therefore a real threat to any trading system operator which could not satisfy the "regulated market" criteria.

The ISD unnecessarily conflates the regulation of corporate disclosure with the regulation of trading systems. "Listing" of securities in conformance with basic standards is held to be a hallmark of a "regulated market", and acquisition of a single passport is therefore made contingent on it. As SEAQ International did not list the continental stocks which it traded in the late 1980s and early 1990s, a formal listing requirement was clearly a threat to its cross-border operations at the time. A north–south split emerged in the Council of Ministers during the ISD negotiations over the appropriateness of a listing requirement, leading to a compromise around a deliberately ambiguous text. Article 1.13 therefore specifies that a "regulated market" must satisfy the requirements of the Listing Particulars Directive (79/279/EEC) "where [the Directive] is applicable". Failure to identify who ultimately determines applicability leads considerable room for protectionism by host state authorities on behalf of their own domestic exchange operators.

The European Shadow Financial Regulatory Committee would like to see a competitive market emerge for listing services in Europe, with non-exchanges competing directly with exchanges for establishing standards appropriate to the age and size of the companies which wish to be publicly traded. Market forces can only improve on the current situation by allowing specialisation between listing service provision and trading service provision (de-linking listing and trading). To move us in this direction, the ISD should be revised to make clear (a) that whereas "regulated markets" may be obliged by home state authorities to deal only in formally "listed" stocks, the actual listing function may be performed by any exchange or other body (such as an accounting firm, rating agency or government institution) duly authorized to provide listing services in any EU national market; and (b) that it is the home state authority which is authorised to decide whether the Listing Particulars Directive is applicable in any given case. This would ensure that a trading system operator designated as a "regulated market" in one jurisdiction is not denied single passport rights in another jurisdiction on the basis that that particular operator does not itself "list" the securities which it trades.

Another potential weakness of the ISD relates to the so-called concept of “new markets”. Article 15.5 states that Article 15 “shall not affect the Member States’ right to authorize or prohibit the creation of new markets within their territories”. This clause is clearly unnecessary if its true intent was merely to reinforce home state discretion in designating “regulated markets”. But the intent was actually to furnish host states with an escape clause from the single passport provision for screen-based trading systems. By declaring a foreign trading system to be a “new market”, a host state could deny it single passport rights. In order to prevent such actions, the ESFRC recommends to eliminate Article 15.5.

4.9. Reform of bank regulation and its application to Japan[25]

Contrary to government claims, the Japanese financial sector remains fragile. A continuation of current policies will increase the cost to Japanese taxpayers. The stock market clearly reflects continued deep skepticism over the sector’s health. Banks are dangerously undercapitalized. Current deposit insurance premiums are grossly insufficient. Lending margins are far too low to cover the post-bubble default risk. The government exacerbates these problems by subjecting private banks to subsidized competition from state institutions, e.g. the postal savings system and Japan Housing Finance Corporation, while pressuring them to increase lending to small and medium-sized enterprises at below market interest rates.

The reported capital of the Japanese banking system is 35 trillion yen, which is overstated by 8.2 trillion yen of deferred tax assets, and includes 7.5 trillion yen of injected government capital which banks are committed to repay. This capital base pales in comparison with unreserved problem loans amounting to about 52 trillion yen. We also note that banks have already lost 66 trillion yen (13% of GDP) since 1992. Massive cross-shareholdings among financial institutions, and between the financial and non-financial sectors, compound the risks to stability. Banks’ corporate shareholdings have recently amounted to almost twice their private capital. Furthermore, banks and life insurance companies have effectively swapped enormous sums of subordinated debt, inflating their regulatory capital while exposing each to the fragility of the other.

The Shadow Committees believe that the Japanese financial system requires the following policy initiatives specified below.

4.9.1. Resolution of weak financial institutions

First and foremost, rapid resolution of insolvent financial institutions is a prerequisite for a healthy financial system. To identify insolvent institutions, a more aggressive write-off of bad loans is required. The resolution of Long-Term Credit Bank of Japan and Nippon Credit Bank raises concerns because no due diligence was carried out before their sale to private investors. Therefore, a blanket government guarantee of the loan portfolio had to be provided by the Deposit Insurance Corporation (DIC). In the future, the blanket should be replaced by an explicit loss-sharing arrangement between the DIC and the buyers.

4.9.2. Capital standards and prompt corrective action

Strict application of prompt corrective action to banks and life insurance companies is necessary. Solvent but undercapitalized banks should be forced to raise equity capital from the private market. Successive failures of life insurance companies that had relatively high reported solvency margins indicate that a strengthening of solvency margin requirements is necessary. In order to put the Japanese financial system on a sound base, it is imperative to remove the effective double-gearing among financial institutions. Banks should be forbidden to hold any instruments counted as capital of insurance companies. The government should remove the DIC protection of subordinated debt. Furthermore, borrowers should be prohibited from buying the subordinated debt of their lenders.

4.9.3. Deposit insurance

After the recapitalization of the banks, the government should eliminate the protection of bank non-deposit liabilities and limit protection of deposits to 10 million yen per customer. Risk-adjusted deposit insurance premiums should be introduced promptly. The postal savings and life insurance systems represent a huge competitive distortion in the Japanese financial markets, and should be privatized

at the earliest possible time. In the short-term, the postal savings system should be subject to taxation, deposit insurance premiums and reserve requirements.

4.10. The regulation of European securities markets: the Lamfalussy report [26]

The introduction of the single currency is creating pressure for common standards of financial regulation, especially with regard to securities markets. Compared to the United States, European capital markets appear to be too small, insufficiently competitive and excessively fragmented. Progress towards a single market in financial services is hindered by the existence of fifteen different national systems of financial legislation and by slow and rigid European Community procedures. The Lamfalussy report, i.e. the final report of the Committee of Wise Men on the Regulation of European Securities Markets, published on 15 February 2001 and adopted by the European Council in Stockholm on 23 March 2001, presents a useful diagnosis of the issues and problems. At the core of these concerns lie the difficulties of implementing reforms through national regulators who, given their inherent risk aversion reinforced by their accountability to national policy makers, have a tendency to exploit any ambiguities in EU Directives in favour of national exchanges and constituencies. The issue is whether the new proposals meet the challenge of overcoming inertia.

In this statement, the European Shadow Financial Regulatory Committee identifies the following shortcomings in the report:

- It is unlikely to achieve its objectives within the stated time frame.
- Its key procedures are unnecessarily cumbersome.
- Political and institutional gridlock is a serious concern.

In order to remedy these shortcomings the Committee recommends the following:

- A simplified legislative procedure involving one rather than two securities committees.
- Accountability to the European Parliament must be a central

feature of this legislative process, including level 2.

- There should be increased reliance on market forces and self-regulation.

4.11. Reforming bank capital regulation[27]

This statement sets out the principles on which a system of bank capital regulation should be based, shows how the proposed New Basel Capital Accord fails to meet these standards, and provides recommendations which would significantly improve capital regulations. These recommendations are based on the strong belief that regulators are not generally in a better position to assess risk than financial market participants.

4.11.1. Principles

All proposals to reform or improve capital regulation should, in our view, adhere to the principles below. While we recognize that making these principles operational and implementing them will have to take account of specific conditions in individual countries, they should nevertheless guide the development and implementation of capital regulation in all countries.

1. Banks should maintain a level of capital that is sufficient to:
(a) reduce the likelihood of bank insolvencies to a level consistent with a stable banking system;
(b) immunize taxpayers from losses incurred by government-guaranteed bank claimants in the event of bank insolvencies; and
(c) align the incentives of bank owners and managers with those of uninsured bank claimants with respect to the risk assumed by banks.
2. Capital should be measured so as to maximize the use of market information.
3. Capital levels and risk exposures should be disclosed publicly and frequently.
4. Bank supervision should be administered by competent regulators who are independent of political and bank industry pressures and are publicly accountable.

5. Rules and supervision should be designed to enhance market discipline.
6. Rules should be designed to identify and disclose connected lending and provide appropriate safeguards.
7. Rules should include an effective mechanism for enforcement of capital regulations.

4.11.2. Inadequacies of the Basel proposal with respect to the principles of capital regulation

1. The Basel proposal will not cause banks to maintain a sufficient level of capital relative to their risk exposures.

The use of a bank's internal ratings provides many opportunities to game the rules. The proposed accord allows banks to use internal ratings under certain conditions, subject to evaluation and acceptance by the bank's supervisory authority. This evaluation is complicated by the fact that banks' practices in credit-risk assessment vary substantially, from the highly intuitive placement of credits into risk categories to the use of fairly sophisticated risk-assessment models. The ability of supervisors to prevent gaming is likely to be limited despite the more intensive supervision recommended in the proposal. This is important because banks have an incentive to minimize required regulatory capital for a given level of economic risk.

External ratings cannot be counted on to measure adequately the risks associated with bank loans. With respect to external ratings, there are a number of difficulties. Rating agencies have little experience in risk-rating bank borrowers; rating each and every bank borrower would be very costly; and the agencies' track record suggests that they have been better at risk confirmation than risk diagnosis. Furthermore, were ratings to be used for the purpose of determining required capital, it is likely that rating firms would be established to provide biased ratings.

A separate concern is that firms and banks in emerging market economies may be adversely affected by any sudden downgrade of their home country's sovereign rating.

2. The proposal does not require that capital be measured on a market value basis.

3. Although the recommendations and requirements for additional disclosures are desirable and will provide more information, the proposal does not go far enough to enhance the role of market discipline in determining capital adequacy. The Basel Committee relies on information disclosure to create market discipline. However, effective market discipline requires not only that information be available to the market, but also that market participants have the incentive to act on it. As long as depositors and other creditors of banks are explicitly or implicitly protected against loss, they will be less inclined to demand relevant disclosure concerning risks or losses and to act on the information that is disclosed.

4. The number and complexity of the proposed rules will make it harder to hold regulators and supervisors accountable for their judgements about bank risk, and may result in increased regulatory forbearance.

5. Regulators need to address more urgently significant conflict of interest problems that have often caused bank failures in many countries, particularly the problem of "connected lending"—loans to insiders, major shareholders, and their affiliates.

6. Although the Basel Committee apparently did not consider enforcement to be within their mandate, it should be clear that no capital regulation regime can be effective without a strong enforcement mechanism.

4.11.3. Recommendations

The following recommendations, which could be adapted to the circumstances of individual countries, reflect our concerns on two key issues. The first one is the need for an effective enforcement regime. The second issue of concern is the fact that regulatory reliance on internal ratings lacks transparency, strengthening the need for supplementary measures aimed at increasing market discipline.

Capital requirements need effective enforcement. In the United States, for example, a system known as prompt corrective action attempts to mimic the sanctions the market would impose in the absence of a government-sponsored safety net. An effective enforcement mechanism based on this model should include the following features:

(1) multiple capital zones with progressively stricter regulatory sanctions;
(2) a specified equity closure rule when the equity is still above zero; and
(3) resolution of insolvencies at least cost to tax payers.

The appropriate amount of capital should resemble what banks would hold in the absence of a government-sponsored safety net. Thus, in addition to the Basel risk-weighted ratios, the relevant capital standard would include a leverage ratio based on total assets (both on- and off-balance sheet assets).

In order to strengthen market discipline, we recommend that banks in industrialized countries issue a minimum amount of credibly uninsured subordinated debt. Holders of such debt are sensitive to and uniquely positioned to monitor default risk. Therefore, the Basel capital rules should be supplemented with signals from these uninsured creditors. To encourage this, we recommend that the distinction between Tier I and Tier II capital be removed.

Although banks face a degree of market discipline from the stock market in most industrialized countries, the information provided by stock prices becomes progressively less reliable as banks approach insolvency.

This subordinated debt proposal can be implemented experimentally in phases so as to minimize costs and permit review of its effectiveness. Initially, the requirement could be limited to large institutions whose debt is actively traded. In addition, at the outset, the market signals from subordinated debt need not mandate any required supervisory action; however, the yields at which this debt trades will provide helpful information to both the market and the supervisors.

In the case of emerging markets, effective use of subordinated debt as capital and as a signal of bank strength may be limited by the absence of a liquid and developed capital market. However, this should not prevent emerging market countries from identifying and developing signals of bank strength—by, for example, encouraging banks to offer credibly uninsured certificates of deposit.

4.12. Re-plumbing European securities markets[28]

The current wave of mergers among securities exchanges has knock-on implications for the structure of securities clearing and settlement in Europe. Until very recently, clearing and settlement systems functioned as utilities serving national needs within Europe's segmented and state-protected capital markets. These systems are now being adapted to the needs of an integrating European securities market. A key question is what role European authorities should have in the restructuring process.

There is widespread recognition across the securities sector that the economies of scale and network effects which characterize the clearing and settlement function are far from being fully exploited in Europe. The barriers to consolidation in clearing and settlement, typically performed by Central Securities Depositories (CSDs), extend well beyond those which derive from distortive government action in the areas of regulation and taxation. They derive fundamentally from the current structure of the market, which is defined by vertical integration of the trading and settlement platforms in a number of major market centres—perhaps most notably, Germany, where Deutsche Börse controls half of Clearstream and has expressed a clear desire to own it outright. The creation of such 'vertical silos' has the effect not only of blocking cross-border mergers of CSDs, but erects a major barrier to competition among exchanges and trading platforms. Creation of such a barrier is, in fact, a significant motivation for the creation of such silos: exchanges owning CSDs can make access to them prohibitively expensive for other trading-system and CSD operators wishing to compete for order flow in the same securities.

It is such concerns that have led to proposals, notably by London Stock Exchange Chairman Don Cruickshank, for the European

Commission to dismantle vertical silos and to "explore how it might force Europe to use a single CSD".[29] The goal is to create a highly regulated monopoly organized along the lines of the US Depository Trust and Clearing Corporation (DTCC), an industry mutual organization mandated by the Securities and Exchange Commission after it obliged US exchanges to divest themselves of their settlement arms three decades ago.

The European Shadow Financial Regulatory Committee does not believe that empowering the Commission to create such a quasi-nationalized industry utility is in the interests of investors or corporate equity issuers. Given the rapid pace of technological advance in the securities sector, no governmental body is capable of substituting its commercial or technological foresight for the critical stimulus of competitive market forces.

We do believe, however, that the creation of vertical silos is inimical to the goal of creating a single European securities market, featuring robust cross-border competition among exchanges and other trading service providers. We believe further that efforts at the European level to regulate the access policies and charges of CSDs controlled by national exchanges, which are currently near-monopolies in their domestic listed securities, are unlikely to be effective. The European Commission has recently suggested that the barriers to competition created by vertical silos be reduced by giving market participants access rights to the CSD of their choice. The effectiveness of such rights would, however, be seriously undermined by necessary exceptions and conditions allowed for by the Commission. Furthermore, the regime proposed by the Commission would inevitably lead to burdensome and impractical regulatory involvement in CSD pricing decisions.

The ESFRC therefore calls for an alternative regulatory regime with a view to (a) maximizing the incentives of CSDs to exploit economies of scale and network effects implicit in their services; and (b) facilitating open and direct competition among trading platforms for European securities.

We propose to bar EU exchanges from owning controlling stakes in CSDs. This may require some exchanges partially to divest

themselves of holdings in CSDs, but would not otherwise involve the Commission or any other government body in the day-to-day regulation of the behaviour of exchanges with respect to their commercial relations with CSDs and other exchanges. We anticipate that such action would, on its own, stimulate a rapid cross-border consolidation of CSDs in Europe. Once the CSDs can no longer be used by exchanges as competitive barriers, they will be compelled to consider mergers as a means of survival: those that do not participate in the consolidation process may quickly find themselves at a competitive disadvantage vis-`a-vis larger scale and lower cost rivals. There are clear parallels with the global custodian industry, which has seen relentless consolidation and falling margins.

Therefore, we see no need to pre-empt this market consolidation through the imposition of a single CSD for Europe as proposed by Mr. Cruickshank. It is better by far that the industry should be reshaped on the basis of market incentives and needs.

We believe that our proposals offer the best prospect of ensuring that the CSD market is contestable and competitive. However, if over time consolidation were to tend towards monopoly – at present a distant prospect – it would be appropriate at that stage to consider regulatory safeguards. We further believe that the EU's regime of 'mutual recognition' combined with 'home country control' is optimally suited to competition-driven consolidation of the CSD industry. Competing CSDs will have a maximum incentive to domicile themselves in national regulatory jurisdictions which allow them to operate at maximum efficiency: for example, we expect that jurisdictions in which the sanctity of netting agreements is inviolate in bankruptcy proceedings will have a distinct competitive advantage over those which do not provide equivalent legal protection for netting. This will rightly drive CSDs into netting-friendly jurisdictions, and encourage other governments to reform their bankruptcy laws accordingly.

4.13. Takeover bids in Europe[30]

European capital markets are becoming increasingly integrated as a result of the introduction of the Euro, the expansion of cross-

border securities investment, developments in information and communications technology, and on-going harmonization of the framework rules for capital markets. This harmonization is a result both of the European Commission's efforts to create a common regulatory framework for securities markets and banking in the EU and competition among national corporate law systems.

In this context, EU-wide rules for takeover bids have been considered vital to the objective of improving Europe's competitiveness, notably facilitating cross-border consolidation of industry. The Commission's aim is to create a vibrant takeover market, providing mechanisms for takeovers and changes in the management of poorly run firms, and reducing the scope for management to extract private benefits. The failure of the last draft of an EU Takeover Directive to achieve a majority in the European Parliament has been considered a setback for the harmonization process. In response to this setback, the European Commission established a High Level Group of Company Law Experts to propose solutions to certain unresolved issues.

The ESFRC has consistently emphasized the desirability of achieving a more integrated capital market within the EU. It is our view that a programme to harmonize rules for capital markets is essential to give EU investors access to securities in all Member States on equal conditions. The determination of corporate law, however, should be largely left to the Member States, pursuant to the subsidiarity principle. Whenever the EU has departed from this principle in the area of corporate law, the results have either been inconsequential or harmful (for example, the imposition of a rigid and expensive regime of mandated capital in the Second Corporate Law Directive). By now there is considerable evidence that it is preferable to allow corporate law to retain a fair amount of flexibility by leaving its structures to competition among Member States.

In this statement, the ESFRC recommends that the EU adopt the following provisions and changes in the proposal for a 13th Directive on rules for takeover bids, in addition to those recommended on 10 January 2002 by the High Level Group of Company Law Experts:

1. The “break-through rule” stating that a bidder obtains control over a firm after having acquired 75% of its risk-bearing capital should be modified by a “grandfathering” clause allowing owners of corporations 5 years to adapt their charters before the break-through rule takes effect.
2. We recommend the incorporation of a rule into the Takeover Directive that would require Member States to enact legal provisions enabling and encouraging their courts to examine and invalidate certain contractual arrangements which serve the primary purpose of deterring takeover bids.
3. Whereas we consider minority shareholder protection an essential feature of securities regulation and company law, this can be achieved effectively in various ways, and not only through mandatory bid rules. Moreover, the effects of mandatory bid rules are uncertain and may vary between countries. We therefore propose that the Directive should not provide for a mandatory bid, but rather that mandatory bid rules should be subject to the subsidiarity principle.

4.14. Reforms in the process of restructuring international sovereign debt[31]

The annual meetings of the IMF and World Bank of September 2002 highlighted two proposals to reform the process for restructuring international sovereign debt: collective action clauses (CACs) and a sovereign debt restructuring mechanism (SDRM), the so- called statutory approach to reform. Neither the IMF nor its critics believe that these measures would be sufficient to minimize the likelihood of sovereign debt crises or to ensure that they are efficiently resolved. Nonetheless the proposals have attracted widespread attention and deserve careful analysis. The Shadow Committees believe that the IMF proposals go both too far and not far enough. They go too far with respect to the immediate reforms suggested for the sovereign debt resolution process. In this context, the Shadow Committees favour a more gradual approach that begins by strengthening existing contractual means for resolving debt problems. They fail to go far enough with regard to reforming the IMF’s policies that give rise to incentives to postpone the recognition and resolution of unsustainable debt.

A central objective of recent reform proposals is to alleviate conflicts among creditors that often arise during the debt renegotiation process. In particular, holdouts by a minority of creditors can delay debt resolution and prevent sovereign debtors from regaining access to international credit sources. The Shadow Committees believe that this problem can be addressed by the general adoption of CACs, which would impose majority rule on bond creditors. The Committees further believe that this goal can be achieved by voluntary actions on the part of creditors and debtors supplemented by the use of incentives for creditors and debtors to adopt CACs. At this time, the Committees do not endorse the adoption of the statutory approach to debt resolution. However, in the event that the use of CACs alone proves inadequate after a period of trial, a statutory approach may have to be reconsidered.

4.15. Corporate governance in Europe[32]

Recent events in the US such as the Enron and WorldCom scandals, as well as difficulties in European companies such as Vivendi, have brought issues in corporate governance back to the fore. In the US, the Enron debacle has inter alia triggered a number of legislative initiatives (such as the Sarbanes-Oxley Act of July 2002). The need for better corporate governance in the EU, and the means of achieving it, are the subjects of this statement from the European Shadow Financial Regulatory Committee. Background includes the November 2002 report by the High Level Group of Company Law Experts, chaired by Jaap Winter (the Winter Group). One motivation[33] for their report is to "co-ordinate and strengthen efforts undertaken by and within Member States to improve corporate governance". The immediate objectives of the Winter Group are improving shareholder protection and restoring confidence in the system, which was shaken by the recent events. But the Winter Group also focuses on improving efficiency and competitiveness of EU firms, aiding in the development of the Single Market and facilitating and empowering growing cross-border investment.

The ESFRC's approach to selected issues in EU corporate governance takes on two dimensions. First, we seek to assess whether self-regulation by firms is adequate to ensure sound corporate

governance or whether regulation by statute is needed. Second, in the case that self-regulation by firms or the private sector is insufficient, we aim to assess whether EU-wide legal harmonisation or national rules are the best locus of regulatory action. We also highlight the existing diversity in corporate governance among states, and that there is no clear "best type" of governance towards which Europe should be moved by regulation rather than market forces. A corollary is that EU countries should not simply fall in line with the US approach but there should be a broad EU–US agreement of rules.

4.15.1. Procedures for improving corporate governance in the EU

There is great diversity in company law and other areas affecting corporate governance within the EU and the diversity will increase further with enlargement in the next few years. It is therefore of great importance for the EU to develop procedures for corporate governance reform which recognise the diversity among states, as well as the diversity of legal areas affecting corporate governance.

With respect to procedures, the Winter report recommends that the Commission should give priority to preparing "a Company Law Action Plan which sets the EU agenda, with priorities for regulatory initiatives . . .", and to "the setting up of a permanent structure to provide the Commission with independent advice on future regulatory initiatives . . .". The Winter Group is obviously inspired by the Commission's initiatives in the financial services sector to develop a financial services action plan, and the Lamfalussy report.

We are concerned that the action plans as well as the type of permanent advisory structures advocated are likely to have an automatic bias in favour of harmonisation. The ESFRC raised this point in its Statement No. 10.

The ESFRC recommends that the Commission and other EU institutions take clear positions on (i) principles for the use of harmonisation versus subsidiarity of legislation and regulation; and (ii) principles for the use of binding directives vs. recommendations and other non-binding means, including private initiatives, for achieving common standards.

It is the Committee's view that harmonisation efforts should largely be constrained to focus on mobility enhancing legislation eliminating explicit hindrances to mobility, as well as government sanctioned discrimination of firms and individuals from different countries. Mobility and non-discrimination lead to competition among national institutional structures and thereby may over time lead to a degree of harmonisation by market forces. In this regard, the Winter report rightly emphasises that hindrances to corporate choice of jurisdiction of incorporation should not be accepted. Such hindrances weaken competition in the area of company law.

Additional criteria for positive harmonisation include a "race to the bottom". However, there is little evidence of such races in the area of company law, and corporate governance more generally. Furthermore, a case for harmonisation can be made to enhance the competitive mechanism, for example, in the area of information disclosure. There are also areas of company law wherein competition among legal and regulatory structures work only very slowly. Market forces could then be "helped along" by EU initiatives, for example, in the case of conflicts of interest between shareholders and management.

Increased use of recommendations by EU could speed up the voluntary adoption of "good practices" (self-regulation), and these practices could be allowed to vary across countries. Recommendations would also make it possible to "test" regulation and legislation in member states that adopt them early before directives are formulated. Clarifying the focus of the permanent structure envisaged in the Winter Report, the ESFRC suggests the setting up of a committee including representatives of all EU countries to co-ordinate national responses to US initiatives such as the Sarbanes-Oxley Act that threaten European firms' access to American securities markets. Coordination in Europe across different areas of law and regulation could also be a task of the new committee.

4.15.2. Key policy issues in EU corporate governance

We now go on to illustrate a suggested approach for the EU to a number of key aspects of corporate governance, highlighting the

ESFRC's agreements and disagreements with the Winter approach in the light of the discussion above.

In the case of disclosure related to corporate governance, the Winter Group proposes EU wide disclosure requirements for listed companies (although detailed rules would be set in Member States) referring to information about key elements of corporate governance rules in an annual statement, remuneration of directors, the costs of compensation schemes, the independence of directors and their qualifications, and group structures. The Committee suggests that disclosure is a case where self-regulation by individual firms has proven insufficient, and we agree that although broad lines could be set by directive, the details should be left to national rules, operating through statute or voluntary agreement. The ESFRC considers that focus on disclosure of corporate governance structures, including shareholders and their links to the company, is welcome and suggest rules could also extend to "open companies". Valuation of share options and their incorporation in profit and loss statements should be a priority for the International Financial Reporting Standards (IFRS). The Committee notes that disclosure can easily be undertaken with an intention to mislead, suggesting that a template or model is needed to help cross-country comparability.

In terms of voting the Winter Group proposes EU wide rules with respect to information about voting, shareholder meetings, and cross-border voting and access to shareholder meetings. Minority shareholders would have a right to request special investigation. Voting is again a case where self-regulation alone has proven insufficient; EU wide rules for cross-border voting and access to shareholder meetings are clearly "mobility enhancing" and the Committee supports it. They tie in strongly with the growth of cross-border investment following EMU. Equally, the suggested special investigation right even for open and closed firms should be commended; it would be a radical change in some EU countries.

The Winter Group proposes the adoption of an EU recommendation strengthening the role of independent directors in audit, nomination, and remuneration committees as well as on the Board. Criteria are laid down for the independence of

directors. The ESFRC is in broad agreement with the focus on independent directors and their responsibilities, as well as the proposed locus of action. On the other hand, stringent rules for board members' qualifications and responsibilities may discourage qualified individuals from board membership and could also cause difficulties in countries where creditor and labour representatives are normally members of the board. The Committee would suggest that a definition of an independent director can be made relatively simple by a negative test which seeks to exclude conflicts of interest in dealings with the executive directors and majority shareholders (if they exist). Furthermore, the Committee goes beyond the Winter Group and recommend a minimum standard for independent board representation, such as 30%. This level is set below 50% for the case where there are but could justifiably be much higher when there are dispersed shareholdings.

The Winter Group proposes EU support for national rules with respect to responsibilities of institutional investors to disclose investment policy and the exercise of voting rights, with voting strategies published and individual votes disclosed to beneficiaries of the institutional investor on request. Voting by institutional investors is again a case where self-regulation alone has proven insufficient in the light of their passivity in the face of management failure and lack of information to beneficiaries, and we agree with EU guidance rather than a recommendation or a directive in the light of different national traditions. The ESFRC suggests to cover all institutions such as pension funds, life insurance companies and mutual funds, which hold assets backed directly by liabilities representing the savings of their beneficiaries. With respect to such institutional investors we would go further than the Winter Group and recommend that institutions be obliged to publish ex post a list of their votes in company meetings for their beneficiaries to examine. To be effective, this will of course require suitable action on voting as outlined above. It will shame those passively voting for management, and allow investigation of conflicts of interest. On the other hand, the Committee agrees that compulsory voting is undesirable as it may induce funds to take positions in areas where they do not have expertise. Furthermore, although it seems unobjectionable to require EU institutional investors also to reveal their investment policies,

this may best be covered by other forms of regulation such as the UCITS Directives.

The Winter Group suggests EU wide rules for responsibility of board members for financial statements. This issue is a case where self-regulation alone has proven insufficient but the ESFRC questions whether an EU Directive is needed since collective responsibility is already enshrined in national legislation. The Committee is in agreement with collective board responsibility for statements, as is current EU practice, rather than individual responsibility as suggested in the US.

4.16. Bank supervisors' business: risk management or systemic stability[34]

In this statement, the European Shadow Financial Regulatory Committee presents objections to the highly complex approach of the draft New Basel Capital Accord (Basel II). We consider it to be excessively focused on the regulation of risk management by individual banks. In addition, we strongly object to the treatment of operational risk, the politically influenced issues around lending to small and medium sized enterprises (SMEs), the insufficient consideration of the issue of pro-cyclicality, and the reduced emphasis on the third pillar, i.e. market discipline. The Committee offers recommendations to deal with these issues and proposes that European authorities apply the substance of the Basel II advanced approach only to very large internationally active banks. Remaining banks would have the option of a simplified standardised approach.

4.16.1. Background

On 29 April 2003 the Basel Committee on Banking Supervision (Basel Committee on Banking Supervision, 2003) issued its third and final consultative paper (CP3) for a New Basel Capital Accord. The New Accord should be implemented in the G10 countries by the end of 2006 for internationally active banks. In the EU, current plans for the Accord apply to all banks and investment firms in an update of the Capital Adequacy Directive (CAD III).

The 1988 Basel Accord was applied consistently in a large group of countries and contributed to an overall increase in regulatory capital. The Accord had some important weaknesses, such as the crudeness of the risk weightings and the consequent risk arbitrage within broad categories of loans. First and second proposals for review were presented in 1999 and 2001. Basel II would comprise three pillars: (1) minimum capital requirements; (2) supervisory review of capital adequacy; and (3) market discipline by public disclosure. Within the first pillar, three approaches were proposed to deal with credit risk: (i) the standardised approach with risk weights based on external credit assessments, and two internal ratings-based (IRB) approaches; (ii) the foundation IRB; and (iii) the advanced IRB. The latter two approaches would be open to "sophisticated" banks, if authorized by supervisors. The proposals also included a requirement for capital to be held against operational risk.

During the consultative processes, concessions have been made to political pressures, such as, for example, in lending to SMEs, retail exposures, credit derivatives and mortgages. The involvement of supervisors in the internal risk management process of banks has also been strengthened in CP3.

In previous statements, the Shadow Financial Regulatory Committees of Europe, Japan, Latin America, and the US have already criticised the proposed New Accord for its complexity and arbitrariness. The New Accord was seen to attach only limited importance to market discipline and to lack an adequate enforcement mechanism.

4.16.2. Regulatory capture, competition, and systemic risk

It is a common phenomenon in all areas of regulation that regulators become "captured" by the industry they regulate, meaning that they take on the objectives of management in the firms they regulate. They may thereby lose sight of the ultimate objectives of regulation. Regulatory capture is particularly serious in industries such as banking where there is a conflict of interest between the firms' objectives (to maximise profits) and the objectives of the regulation (to provide consumer protection and maintain systemic stability).

The complexity of Basel II and the role assigned to national supervisors make an arm's length relation between regulators and the regulated nearly impossible. While the traditional role of supervisors is to oversee banks' implementation of rules designed to enhance consumer protection and financial stability, the CP3 assigns supervisors roles that make them deeply involved in the micro decisions of risk management. Since banks have an a priori advantage in both technical competence and the knowledge of their specific techniques, supervisors will have to acquire the corresponding knowledge or remain unable to supervise properly. The banks and the supervisors have already had to work together in Basel II and further collaborative work is needed to resolve the many issues left to be determined on the national level.

The deep involvement of supervisors as regulators and risk managers implies that any bank failure may be viewed as the failure of the supervisor, and indirectly of the government. The reluctance to allow banks to fail may increase further, with the consequence that risk-taking incentives of banks are not reduced as intended in Basel II. The risk of systemic crisis may actually increase rather than decrease as intended. The vicious circle of incentives for risk taking, an increased need for supervisory involvement, and increased capture of regulators would undermine the whole aim of the internal ratings-based approach.

4.16.3. Information disclosure and market discipline

The risks of regulatory capture can be reduced by increased market discipline. CP3 weakens information disclosure requirements, notably on internal ratings. Moreover, it leaves the detailed decisions on information disclosure to national supervisors, who may compete in laxity. We continue to recommend mandatory issue of subordinated debt to improve market discipline.

4.16.4. Capital requirements for operational risk

Operational risk is different from credit and market risk. It refers to the causes and not the consequences of losses. Reduction of operational risk is fundamentally related to good management.

The right medicine for operational losses is not equity capital but effective corporate governance, early planning and insurance.

The CP3 specifies three approaches to calculation of capital requirement for operational risk. Two of them (the “basic indicator approach” and the “standardised approach”) are based on gross income in the bank as a whole or in specific areas. The rubric for the third “advanced measurement approach” shows that the Committee is highly aware of the weak conceptual foundation of an operational risk charge when the Committee suggests that banks will be given an “unprecedented amount of flexibility” to develop approaches to measure the risk.

The proper context for dealing with operational risk is pillar 2 (supervisory review) but the ESFRC accepts as a pragmatic adjustment a flat charge (corresponding to the basic indicator approach) to compensate for the reduction of capital in the banking system due to the new credit risk regime.

4.16.5. Quantitative impact study 3

On 5 May 2003 the Basel Committee published an overview of global results with respect to the third quantitative impact study (QIS3). The objective of the study is to gauge the impact of the latest Basel II proposals on minimum capital requirements. For the standardized approach the QIS3 reports a moderate overall (i.e. credit risk and operational risk) increase in regulatory capital requirements. Larger banks face an 11 and 6% average increase in the G10 and EU, respectively, while smaller banks are confronted with a 3 and 1% increase, respectively. The results are quite different for the IRB approaches. In the foundation IRB approach the average capital requirement for smaller banks decreases by 19 and 20% in the G10 and EU, respectively, while it remains about the same for larger banks (3% increase in the G10 and 4% decrease in the EU).

The ESFRC thinks these estimates are too conservative, and there will be a substantial overall reduction of the regulatory capital requirement. We base this assessment on the fact that the Basel Committee itself says that it believes the results, particularly from non-retail activities, tend to overstate the minimum capital

requirements on implementation. This is particularly the case in the area of credit risk mitigation, where it has proved difficult for banks in many countries to recognise all the types of collateral which are allowed to reduce the capital requirements.

QIS3 implies that, most likely, the regulatory capital requirement on implementation will be substantially lower than the current projections. This significant reduction in the amount of capital held by banks in the EU and G10 is contrary to the stated objective of the Basel Committee, and it may have potentially adverse consequences for the stability of the banking system.

4.16.6. How should the EU react to the US approach?

On its adoption, the US authorities have proposed that Basel II should only be applied on a compulsory basis to around 10 large internationally active banks. The authorities expect that another 10 banks will adopt it voluntarily. The remaining banks would be subject to a national version of the 1988 Basel Accord. The rationale for this decision relates inter alia to the complexity of the framework for all parties, including regulators and senior bank managers. We acknowledge the basis of the US approach and share the worry about complexity, but we are also concerned about the implication of the US approach for a level playing field, and the repercussions for banking systems outside the G10.

At the EU level, the ESFRC recommends the adoption of a CADIII which would make Basel II mandatory only for the large internationally active banks and investment firms. Smaller institutions should have the option of adopting either a simplified version of the "standardised approach" or the new rules if they consider it in their interests to do so.

4.16.7. Small and medium-sized enterprises (SMEs)

The ESFRC regrets that the issue of capital requirements for SMEs has become a political issue rather than an economic one. If there are distortions in the credit markets for SMEs, they should be remedied through fundamental reform accompanied by transitional

measures and not by ad hoc approaches favouring SMEs, such as differentiated capital requirements based on the size of the borrower or reclassification of smaller loans as retail.

4.16.8. Pro-cyclicality

Implementation of Basel II may increase the pro-cyclical effects of capital requirements, because banks will have to increase their capital bases in recessions when borrowers appear more risky. Even though some pro-cyclicality is inevitable, regulatory measures should not aggravate it. The issue deserves careful attention and requires further analysis. One way of mitigating pro-cyclicality is through dynamic provisioning, wherein provisions are built up in good times in order to enhance the resources to cater for defaults in bad times. This inter-temporal perspective could be a useful complementary approach to Basel II, and it will help to preserve both macroeconomic and financial stability.

4.17. Credit risk transfer from banks to non-bank financial institutions[35]

During the past 5 years banks have shifted vast amounts of credit risk to non-bank financial institutions and to other banks. In Europe and the USA banks have been net buyers of credit protection by selling loans directly or indirectly through securitisation, or by buying credit derivatives. The notional value of the market for credit derivatives alone is expected to more than double from USD 2 trillion in 2002 to USD 5 trillion in 2004, possibly exceeding 10% of the loan stock. According to Fitch (September 2003) the insurance industry has absorbed USD 381 billion worth of credit risk through derivatives. Of this amount USD 229 billion originates in the banking industry.

The phenomenon of trading in risk and shifting it from one kind of institution to another does not necessarily increase financial instability. It may rather increase the ability of the financial system as a whole to absorb risk and it may improve the efficiency of risk allocation. Trading in credit risk also enables banks to adjust the risk profile of their portfolios. Nevertheless, the rapid increase of

trading in, and shifting of, risk has become a concern of regulators and practitioners.

4.17.1. Trading in risk and efficiency

In spite of their expertise in credit risk evaluation, banks may be less suited than other financial institutions to bear a substantial amount of credit risk. It may thus be appropriate for them to sell credit risk to those with stronger ability to bear such risk. This is the case if financial markets are well functioning in the sense that the incentives of sellers and buyers are not distorted, and information is available to all actors in the market place. Even if there are distortions, trading in risk is efficient provided that regulation corrects for these distortions by means of, for example, capital requirements. A part of the credit risk transfer seems to be driven by arbitrage opportunities arising from different regulatory capital requirements applied to different kinds of financial firms, e.g. an insurance company is buying a loan from a bank since it faces a lower regulatory capital requirement on the loan. The financial advantage of achieving a more favourable expected return/required capital ratio can be divided between the bank and the insurance company. Under what conditions can the shifting of risk increase systemic instability and reduce the efficiency of the allocation of risk? We identify the following possible sources of excessive risk taking in the financial system as a result of banks' shifting of risk to non-banks financial institutions and life insurance companies in particular:

1. Banks may be able to evade the burden of capital requirements by selling risk.
2. Risk may be shifted to institutions with inferior expertise in risk evaluation, or lacking incentives to monitor.
3. There could be conflicts of interest among different entities within a financial conglomerate with respect to risk bearing.

4.17.2. Banks may be able to evade the burden of capital requirements by selling risk

Banks have an incentive to, e.g. securitise loans if they thereby can reduce capital requirements and sell the securities to firms that do

not face similar constraints. They may then provide further lending and develop customer relations. The contracts associated with securitisation are often quite complex, however, with the consequence that it is unclear how much of the original risk ultimately remains with the bank. Furthermore, much of the legal framework enabling securitisation is untested. Thus, the originating bank may face substantial legal risk in times of stress.

A bank selling risk may also put its reputation as credit evaluator and monitor at stake. Therefore it may find it justified to bear a proportion of losses associated with the sold risk in order to retain its credibility. Capital should appropriately be held against such reputational risk, as well as legal risk although these risks are not captured by the current Basel capital adequacy rules.

4.17.3. Risk may be shifted to institutions with inferior expertise in risk evaluation, or lacking incentives to monitor

Typically, credit risk is transferred from banks to insurance companies, as well as to pension funds, other banks, and in some cases also non-financial corporations. The question arises whether non-banks that buy the risks are sufficiently aware of the risks they are taking over. Insurance companies have built up much less experience than banks in this field. At least, insurance companies are facing a learning phase in which they have to professionalize their risk assessment capabilities. The problem of adequate risk assessment is exacerbated by the non-transparent nature of the markets for bank loans and credit derivatives (lack of data, different accounting methodologies, etc.). Some insurance companies have already discovered their underestimation of the transferred credit risks and decided to slow down their activities in these markets.

Regulation might aspire to actively assure that those who buy or absorb risks do not underestimate the risks and absorb more risks than they can bear given their equity buffer. The need for active intervention is all the more likely, if the relevant information is not available to shareholders and potential buyers of new insurance policies, and if switching between insurance companies is difficult for those who already hold a policy.

History and theory offer grounds for caution in the rapid growth of markets for new financial instruments, such as credit risk transfers, before the market participants have experienced a full range of economic conditions. Although there have been some major defaults in the recent recession, such as those of Enron and Worldcom, these have not been on the scale, e.g. of those observed in 1990–1992, when there were correlated downturns in commercial property markets following a boom in lending. The growth of the markets for credit risk transfer instruments has been explosive since the recession and any periods of extreme stress have not yet been observed. Therefore, it is difficult to make probabilistic assessments of potential losses. Under such circumstances there is a danger that risk pricing will be inaccurate and capitalisation inadequate.

Aggravating the situation in the short term is the fact that information on exposures to CRT instruments is inadequate, both in terms of the volume of exposures by each institution and the varied terms under which exposure is transferred. Lack of disclosure by individual institutions is reflected in inability of authorities to detect the sectoral or national location and concentration of credit risks transferred.

Regulators can help improve market discipline by enhancing transparency. This can be accomplished by requiring insurers and similar risk-takers to disclose their financial situation fully and in a timely manner along the lines suggested by the International Accounting Standards Board (IASB)—something which is not yet common practice in all European countries, as shown by recent developments in Germany.

4.17.4. There are conflicts of interest among different entities within a financial conglomerate

Markets for many financial services are dominated by entities belonging to financial conglomerates wherein, for example, a bank and an insurance company may co-exist. If the markets for one of the financial services offered by the conglomerate are not competitive, the entity operating under imperfect competition may price its services to serve the goals of a particular stakeholder group at the expense of

another. If so, the governance of the group and its entities becomes a concern. For example, in a conglomerate consisting of a bank and a life insurance company, the life insurance policy holders have an interest in retaining short term profits within the life insurance company in order to offset possible future declines in asset values. At the same time the shareholders may have an interest in having profits distributed. This conflict of interest is aggravated if the life insurance company is governed as a mutual company in which profit distributions are restricted, while the conglomerate as a whole is incorporated. In many European countries life insurance companies are governed as mutuals while being part of an incorporated group. Within such groups it could be advantageous for shareholders to overprice credit risk transfers to the insurance company in order to shift profits from the mutual life insurance company to the company that does not face restrictions on distributions. Safeguards against such internal profit transfers can be created by strengthening the separation of the governance structures of the different entities.

4.17.5. Recommendations

Integrated regulation may be a suitable response to the heightened mutual risk exposure of the bank and non-bank financial sectors generated by credit risk transfers. The aim should be to ensure that "best practice" in risk management is utilized in all types of financial institutions.

Haste is needed in the implementation of risk sensitive regulation that encourages market discipline across the financial sector. Market discipline needs to be complemented by macroprudential surveillance procedures which evaluates aggregate credit risks, inter alia via stress testing of credit risks at a financial sector and economy wide level.

Transparency must be emphasised. Insurers and similar risk-takers should be required to disclose their financial situation fully and in a timely manner along the lines suggested by the International Accounting Standards Board (IASB). This will also facilitate the sharing of data and benchmarking across Europe.

We question whether it is appropriate that within an incorporated financial conglomerate one or more entities are governed as mutual

companies, wherein the interests of major stakeholders differ from the group shareholders' interests. Where this is the case independent governance of the mutual should at least be assured.

4.18. Challenges to financial regulators in the accession countries[36]

1 May 2004 marked the entry to the EU of ten new members, of which eight are central and eastern European (CEE) countries. Since 1989, these countries have made remarkable progress in the transition to market economies and the development of their financial sectors. Furthermore, they have nearly completed the implementation of all EU laws and regulations into their national legal frameworks.

The banking sectors in the CEE countries are predominantly in private hands. Banks also appear to be profitable with healthy capital ratios in most of the countries. A striking result of the transition process is that the banking systems have become dominated by foreign-controlled banks. The share of total bank assets held by foreign-controlled banks exceeds 70% in most of these new member states, with one notable exception being Slovenia, where the foreign share in the state-dominated banking system is less than 20%. The foreign control of the CEE banks, which typically are operated as subsidiaries, as well as the typically high degree of market concentration among them, create challenges for regulators with respect to the supervision of the foreign-owned banks, and the development of securities markets.

4.18.1. The need for coordination of home and host country banking supervision

As is standard in international supervisory practice, the responsibility for supervision of a subsidiary is placed on both the home and the host country supervisor. The joint responsibility is asymmetric in that the home country supervisor has the responsibility to view the subsidiary in the context of the entire institution, while the host supervisor focuses solely on the subsidiary itself. Whereas there are generally frequent contacts between the supervisors, the degree to which the home country supervisor is obliged to share

information about the bank is rather unclear. In a Basel Committee document from October 1996 on "the supervision of cross-border banking", paragraph 30 refers to the information flows from home to host supervisor. This paragraph states that keeping host supervisors appraised of "material adverse changes in the global condition of the banking groups operating in their jurisdictions [. . .] will typically be a highly sensitive issue for home supervisors (both with respect to substance and timing) and that decisions on information-sharing necessarily will have to be made on a case-by-case basis" (our italics). The EU Consolidated Banking Directive of 2000[37] refers in Article 56 to measures to facilitate consolidated supervision. Accordingly, the competent authorities of each member state shall communicate to each other "all relevant information which may allow or aid the exercise of supervision on a consolidated basis". In our view, however, it does not materially strengthen the requirement for provision of information by the home to the host supervisor.

Potential for deficiencies in the sharing of information creates scope and incentives for increasing the risk of host country subsidiaries. Specifically, if a multinational bank as a whole is facing distress, it might shift risk to the subsidiary where it expects the greatest government support. If the subsidiary goes bankrupt, it is the deposit insurance system in the host country which is responsible for providing support. This implies losses, which are borne by the local taxpayers. High banking concentration in a host country adds to the likelihood of a bail-out, because the government may not be willing to accept the failure of a subsidiary which constitutes a substantial part of the country's financial system. Under these circumstances, the subsidiary is likely to take increased risks in the host country. Such behavior would become even more serious for the host country, if the home supervisor can avoid responsibility for the bank's distress by forbearance regarding potential insolvency, which may lead it to indulge the bank's transfer of risk to the subsidiary.

The ESFRC notes that some of the new member states have quite strict provisioning requirements, and we surmise that this may result from concerns about the lack of information provided by home country supervisors about the parent institutions. To the extent that these requirements go beyond what would be strictly necessary to

maintain financial stability with full information available to host supervisors, they constitute a cost in terms of inefficiency for the domestic economy.

In order to counterbalance the perverse incentives described above, the ESFRC recommends that the scope of provision of information from the home country supervisor to the host country supervisor should be broadened substantially in respect of the health of the institution as a whole. The increased flow of information to host country supervisors would be of particular benefit to the new EU entrants given the scope of foreign bank activity. Besides the benefit in terms of financial stability, it could reduce the need for the strict current provisioning requirements and their related costs identified above.

An information sharing requirement would also be helpful in terms of the implementation of Basel II, where the internal ratings systems of the subsidiaries need to be validated by both home country and host country supervisors. It would benefit in particular the host supervisors in the new member states having important foreign subsidiaries, who are already facing problems with such validation given shortage of resources and statistical data problems.

4.18.2. The role of securities markets

The dominant role of a few foreign banks in many of the new member states accompanies a financial structure where financing options are limited. Firms remain restricted in their choices of funding sources, and households have a limited number of investment alternatives. Securities markets can provide an alternative source of external financing for firms as well as a placement for households, but these markets remain unimportant in CEE countries in spite of encouragement by governments. Notably, they have so far failed to provide consistent liquidity, except for a limited number of stocks.

To some extent, it is natural for securities markets to develop gradually during the process of financial development. Nevertheless, for the sake of sustained economic growth it is desirable that conditions be provided for securities markets to expand. This does

not imply that we favour government-sponsored or subsidized stock markets in each country. In our view, it is not even necessary that each country has its own stock market, particularly in the perspective of future entry to the euro zone. Rather, securities markets should be allowed to emerge freely and to compete for firms and investors. What is important is that:

1. Firms are able to find the cheapest source of funding by means of issuing equity and other securities where they think it is to their advantage. These considerations should exclusively determine the decision whether and where to list.
2. Domestic investors must be able to trade as safely and readily in foreign as in domestic securities markets.

Even though many firms are currently not in the position where issuing equity or bonds would be attractive, the emergence of liquid markets would encourage the use of private equity and debt financing. This is also important for early-stage financing, because the venture capitalist usually has the exit route of placement in equity markets as the final objective. Venture capital financing is often superior to bank financing of early stage projects, because banks are not willing to take the risks involved in such projects, where collateral is limited. Furthermore, venture capital firms supply advice and capabilities at critical growth phases.

Another benefit of securities markets is that they provide the opportunity for more established firms to issue listed and unlisted debt securities. Medium-term bonds, commercial paper and other forms of structured finance can replace bank loans and improve firms access to funding.

The EU provides a regulatory framework for securities markets through many directives which are being implemented by the new member states. This legislative process has the intention both to allow domestic markets to emerge and to enable cross-border transactions by investors and exchanges. The new member states need to take full advantage of the opportunities that this process provides. For securities markets to function effectively liquidity is essential. It requires a sufficient number of participants with access to reliable

information. In this context, we note that pension funds are growing rapidly in many of the CEE countries, following early reform of unsustainable pay-as-you-go systems. Pension fund growth will spur development of securities markets in the CEE, and entry to the EU should facilitate this for pension funds falling under the Institutions for Occupational Retirement Provision Directive of 2003. Article 18 generally mandates governments to require such institutions to invest in accordance with the "prudent person rule", and not to prevent pension funds from investing up to 70% of assets in equities and corporate bonds (or 100% where members bear the risk). They must also permit currency mismatch for up to 30% of portfolios. This will entail a marked easing of the relatively strict portfolio restrictions imposed hitherto in some CEE countries, and hence permit wider equity investment. We recommend that CEE countries should not take unjustified advantage of the Clause 6 of Article 18 permitting more stringent investment rules on an individual basis "provided they are prudentially justified".

4.19. Common features of all statements

So far, there has not been a clearly discernible logical sequencing of, or connection between, the various topics that have been selected for discussion in the statements of the European Shadow Financial Regulatory Committee. There are so many problems in the field of financial regulation which should be addressed from a European perspective that there does not seem to be much of a need for the ESFRC to choose its topics on the basis of a particular strategy. However, in terms of the fundamental approach they take to regulatory and supervisory issues, the various statements have a great deal in common, and this is certainly not a coincidence. In all of the statements, problems of financial regulation and supervision are viewed and discussed as incentive problems; and in each case the recommendations are intended primarily to bring a specific incentive problem more clearly into focus and to devise better, i.e. more incentive-compatible, solutions to this problem.

There are always incentive problems at two levels: at the level of the economic units that are subject to a given regulatory standard or scheme, there will be incentives for such entities to act in ways

which are contrary to the interests of the regulating and supervising agencies, or at least contrary to their declared objectives. For instance, individual banks might be inclined to issue too many loans with highly correlated risks. At the same time, there is typically also an incentive for the regulating agency, or for individual people working there, to act in ways which are contrary to its overall interests as an institution and to its declared aims in a given situation. Regulatory forbearance, the view that some banks are "too big to fail" and various types of interventions in problem banks are manifestations of this problem of misaligned incentives and time inconsistency.

The incentive problems at both levels are aggravated, or caused in the first place, by information problems. This sheds light on an additional layer of incentive problems. In many relevant contexts, the incentives to produce, reveal, collect and disseminate the required information are not structured in an optimal way. Incentive and information problems are intertwined and they tend to be mutually exacerbating. The recommendations of the ESFRC are invariably based on the premise that if regulation is to be effective, it must address the web of interdependent incentive and information problems at both levels and also mitigate those problems at both of the levels at which they are encountered.[38] The statements of the ESFRC tend to confirm that such a comprehensive approach, which is also in line with the theory of optimal financial system design, is useful and that it can be put into practice.

5. ASSESSMENT AND OUTLOOK

As we have tried to argue, the task of financial regulation is essentially one of solving incentive problems, and, more specifically, it is one of creating the right incentives for both regulated institutions and regulators to produce, communicate and use the right kind of information in the right way. Every kind of regulation that is undertaken at the European level has to cope with the additional problem that the various European countries, and particularly their financial systems, differ widely and in important respects.[39] These differences cannot be ignored, as the European Community had correctly recognised by the early 1980s. Therefore, producing,

communicating and using the right kind of information in the right way may mean different things in different countries, and if financial regulation at the European level is to be both effective and appropriate, it must be designed in such a way as to be compatible with the legal, cultural, economic and social systems of the individual countries in which it is to be applied. In practice, though, this means that there are indeed issues in financial regulation for which an optimal Europe-wide policy cannot be devised,[40]or for which a policy that might be considered optimal could not be successfully implemented. But the fact that there will not always be a first-best solution that can be implemented at the European level should not be used as a pretext to stop looking for optimal regulatory strategies for Europe as a whole. Indeed, while it is important to bear in mind the constraints faced by any attempt to arrive at a common solution to concrete problems, it is equally important to recognise the potential benefits of a transnational approach. Giving due consideration to both aspects constitutes, in our view, a contribution to the development of a specifically European "regulatory culture".

In its own work, the European Shadow Committee faces problems that are analogous to those which it tries to address in its statements. Indeed, in the activities of the ESFRC incentive and information problems and issues of heterogeneity are intertwined in a complex way, and they make certain things difficult and others quite simply impossible. Nevertheless, the attempt to overcome these problems seems well worth the effort it entails. Almost by necessity, the European Shadow Committee is a bold, perhaps even audacious, undertaking. After all, it involves the operation of a group which has no formal mandate from any body or institution, whose members cannot be obliged to attend its meetings regularly, and whose meetings are in any case relatively brief and infrequent, but whose purpose is to produce meaningful statements and issue recommendations on important and difficult problems. Only time will tell, and others will have to judge, whether this kind of undertaking is, in fact, feasible and useful and whether the ESFRC can achieve the goals it has set for itself.

The incentive and information problems which the ESFRC faces in its work are probably the most serious potential obstacles to the

success of its activities. There are two main issues here. First, there is the question of whether it is feasible to mobilise the information which the committee members are assumed to have and to communicate, process and transform it within the group and disseminate the outcome, and the related question of where the incentives to reveal information come from. Second, there is the simple fact that the statements of the ESFRC can only reach the regulatory community, if the information which they contain is sufficiently interesting to motivate journalists, who are needed as intermediaries and "multipliers" in the dissemination process, to come to the press conferences, listen to what is said at these presentations, read the statements on their own, and then write about them. But they obviously cannot be forced to play this role. Finally, the statements must be sufficiently useful to regulators to make them want to read what the ESFRC has to say and to consider its recommendations. And this means that they also need information and incentives, which must be provided by the statements.

Thus, information and incentive problems are relevant on various levels. Like financial regulation, the "ESFRC project" itself can usefully be regarded as a problem of mechanism design. Obviously, the production of uninteresting, irrelevant or simply erroneous statements would be a reason for the various parties whose co-operation is required to achieve the committee's objective – the members, the "multipliers" and the regulators – to stop playing their respective roles. Only time will tell whether they will continue to co-operate in this undertaking over the long term, but based on the experience of the ESFRC so far, we are fairly optimistic that this will be the case.

Heterogeneity is also an important potential constraint for the ESFRC, given the diversity of its members' specific areas of interest and academic backgrounds and the broad range of countries from which they come. To a certain extent, however, this heterogeneity is clearly a positive feature: a – fictitious – member from Norway would be able to draw upon different kinds of experience, and would give priority to different issues, than one from Portugal. This ensures that a great deal of information is presented for consideration at the committee meetings. Also, the fact that, at least to a certain extent,

each member must expect to be held accountable for the statements of the ESFRC is clearly positive. It strengthens the members' incentives to reveal information and to become actively involved in candid, and sometimes rather heated, discussions of controversial issues, and it ensures that the group does not issue statements precipitously or adopt unsound positions.

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[1] For discussions of the rationale for banking regulation, see Bhattacharya et al. (1998), Burghof and Rudolph (1996), and Dewatripont and Tirole (1994), and for a presentation of the rationale for the regulation of capital markets, see Pagano and Röell (1992).

[2] On this point, see the instructive discussions presented in Herring and Litan (1995) and in Burghof and Rudolph (1996).

[3] With respect to the Basel Committee, this negative aspect of international co-operation between regulatory and supervisory agencies is discussed in detail by Herring and Litan (1995, p. 132ff).

[4] Since 1973, this group has regularly issued assessments of US monetary policy, and its statements have invariably attracted a great deal of attention in the press and in other media.

[5] The members are: Harald Benink, Erasmus University, Rotterdam; Tom Berglund, Swedish School of Economics and Business Administration, Helsinki; Franco Bruni, Bocconi University, Milan; Philip Davis, Brunel University, London; Hans Geiger, University of Zurich; Friedrich Kübler, JohannWolfgang Goethe University and Clifford Chance, Frankfurt/Main and University of Pennsylvania, Philadelphia; Karel Lannoo, Centre for European Policy Studies, Brussels; Rosa Lastra, University of London; Jacek Rostowski, Central European University, Budapest; Reinhard H. Schmidt, Johann Wolfgang Goethe University, Frankfurt/Main; Benn Steil, Council on Foreign Relations, New York; Niels Thygesen, University of Copenhagen; and ClasWihlborg, Copenhagen Business School. Former ESFRC members are Christian de Boissieu, University of Paris I, Sorbonne; Jordi Canals, IESE Business School, Barcelona; Richard Dale, University of Southampton; David Llewellyn, Loughborough University; and Heinz Zimmermann, University of Basel.

[6] See, for example, Demirgüc-Kunt and Detragiache (1997) and Caprio (1997).

[7] Cf. Basel Committee on Banking Supervision (1988, 1996, 1999, 2001, 2003, 2004) and Deutsche Bundesbank (1998).

[8] For a discussion of these effects, see Bhattacharya et al. (1998), Burghof and Rudolph (1996, p. 46ff), Demirgüc-Kunt and Huizinga (1999), and Freixas and Rochet (1997, Chapter 9).

[9] So far, there have been several cases in which draft statements on

two different topics were prepared for a meeting of the ESFRC, but there has been only one case in which two statements were actually issued. Whenever draft statements have been prepared on more than one subject, the decision as to which topic, or topics, should be addressed at the press conference is always one of the first items on the agenda of the meeting.

[10] 10 So far, interest on the part of the relevant newspapers and periodicals has been strong: among other publications, Financial Times, The Banker, Financial Regulator, and Handelsblatt have reported on the statements in detail.

[11] The statements are also published on the website of the Brussels-based Centre for European Policy Studies: www.ceps.be and on the website of the American Enterprise Institute: www.aei.org.

[12] This meeting was very important and productive in terms of its output. However, it was also important because it highlighted certain constraints faced by groups such as the ESFRC which are an outgrowth of their organizational structure and procedures: the group that met in New York – which consisted of the US SFRC, the ESFRC and members of the Japanese Shadow Committee – was too large to permit the kind of intensive deliberation needed to produce a joint statement more or less "from scratch". The process of establishing a consensus was greatly facilitated by a draft paper prepared by the US Shadow Committee, which provided a starting point for the group's discussions.

[13] This is the title of the first statement issued at a meeting in London, June 1998.

[14] This is the title of the second statement issued at a meeting in Frankfurt, October 1998.

[15] This is the title of the third statement issued at a meeting in Paris, March 1999.

[16] This is the title of the fourth statement of the ESFRC, which was prepared at a joint meeting of members of the US, Japanese, and European Shadow Committees (New York, June 1999).

[17] Cf. Basel Committee on Banking Supervision (1999). This preliminary draft version of a new capital adequacy framework was published on 3 June 1999, and the Basle Committee indicated that it would produce a revised version in approximately 1 year's time. Persons and institutions wishing to make their views on the preliminary draft known to the Committee were invited to submit

their comments during this period.

[18] The procedure for calculating the minimum capital level, which was established in the 1988 Basel Accord defined the minimum capital requirement as a function of the amount of banks' risk-weighted assets. Originally, this procedure was intended to be employed only in the case of internationally active banks. In the meantime, though, it has been adopted in almost all countries, and the national regulatory agencies that employ this procedure require it to be used for all banks. A number of authors have pointed out that this "one-size-fits-all" approach does not always make sense, and that it can have particularly unfavourable consequences in developing countries; on this point, see in particular Dziobek et al. (1995), who provide a broad overview of the relevant issues, and Schmidt (2000), who addresses certain key topics in greater detail. It can be expected that, like the existing "Basel standard", the revised version of the capital adequacy framework will be almost universally adopted and applied by national regulatory agencies, and this is why the preliminary draft prepared by the Basel Committee last year has attracted so much attention and has been subjected to such intense scrutiny.

[19] The current risk weighting system is biased in favour of loans to OECD countries and loans to certain financial institutions. Moreover, all loans to the private sector are put in the same risk category.

[20] This is the title of the fifth statement issued at a meeting in Milan, October 1999.

[21] This is the title of the sixth statement issued at a meeting in Brussels, February 2000.

[22]This is the title of the seventh statement, which was also issued at the Brussels meeting in February 2000.

[23] For an extensive analysis of this issue see Benink and Wilhborg (2002).

[24] This is the title of the eighth statement issued at a meeting in London, June 2000.

[25] This is the title of the ninth statement of the ESFRC, which was prepared at a joint meeting of members of the US, Japanese, and European Shadow Committees (Tokyo, October 2000).

[26] This is the title of the tenth statement issued at a meeting in Madrid, March 2001

[27] This is the title of the eleventh statement of the ESFRC, which was prepared at a joint meeting of members of the US, Japanese,

Latin American and European Shadow Committees (Amsterdam, June 2001).

[28] This is the title of the twelfth statement issued at a meeting in London, November 2001.

[29] International Finance, Summer 2001.

[30] This is the title of the thirteenth statement issued at a meeting in Copenhagen, February 2002.

[31]This is the title of the fourteenth statement of the ESFRC, which was prepared at a joint meeting of members of the US, Japanese, Latin American and European Shadow Committees (Washington DC, October 2002).

[32] This is the title of the fifteenth statement issued at a meeting in London, December 2002.

[33] The new report issues recommendations for legislation and other EU initiatives in the areas of corporate governance, capital formation and maintenance, groups and pyramids, corporate restructuring and mobility, the European private company, and co-operatives and other forms of enterprises.

[34] This is the title of the sixteenth statement issued at a meeting in Basel and Zurich, May 2003.

[35] This is the title of the seventeenth statement issued at a meeting in Paris, October 2003.

[36] This is the title of the eighteenth statement issued at a meeting in Budapest, May 2004.

[37]Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126 26/05/2000.

[38] This is also the position taken by Bhattacharya et al. (1998) and Boot and Thakor (1993).

[39] For an analysis of key structural differences between the financial systems of various countries, see Hackethaland Schmidt (2000) and, with a special focus on the case of Germany, Schmidt and Tyrell (2004).

[40] In Hellmann et al. (2000), convincing arguments are advanced to show that a uniform system of regulation can prove to be problematic at a fundamental level, if there are significant differences in the operating environments of the banks it covers.