Lorenzo Bini Smaghi: The economic governance of the European Union in the light of the Treaty of Lisbon – harmonisation or competition between countries?

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the conference on ”The European Central Bank: a new actor on the international scene”, Milan, 24 January 2008.

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Introduction[1]

It is a great pleasure for me to speak at this conference, which gives us the opportunity to take stock – some ten years since the start of the Economic and Monetary Union – of the institutional framework for the governance of the European economy.

The book entitled “The Law of the European Central Bank” by Chiara Zilioli and Martin Selmayr, which looks at the legal framework of the European Central Bank, is a good place to start. Ten years on, it is possible to question whether this framework is still valid.

I should specifically like to focus on an area of particular interest, especially in the light of recent events. The new Treaty of Lisbon, which was signed by the Heads of State or Government and the Finance Ministers of the 27 European Union Member States last December, did not make any substantial changes to the governance structure of the European economy. There continues to be a contrast between a fully-integrated monetary system, with a single monetary policy decided by the European Central Bank, and a financial market that is only partially integrated, since regulatory and supervisory policies are implemented at national level. This issue, which is quite complex, has been studied by various commentators, academics and officials.[2] The question is whether the current institutional framework is adequate given the accelerating process of market integration and the market turmoil experienced in recent months, or whether it should instead be strengthened in order to ensure an effective regulation of the markets.

I intend to address these issues mainly from an economic perspective, leaving to the legal experts the task of outlining their legal-institutional vision in this regard.

1. The new Treaty: innovation and continuity

I do not intend to discuss either the controversy or the difficulties encountered during the process of revising the Treaty, which took seven years: from the Presidency Conclusions of the Nice European Council at the end of 2000, through the draft European Constitution outlined in 2004 and the negative referenda on the Constitution in France and the Netherlands in 2005, to the signing of the Treaty of Lisbon in December 2008. I should only like to point out that, despite the discussions which took place in various quarters in parallel to the institutional debate and the positions taken by academics, commentators and politicians, all the official documentation drawn up during that time, from the Constitution to the Treaty of Lisbon, underlines the political will to grant a strong independent status to the ECB and the national central banks (NCBs).

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[1] The points of view expressed are solely those of the author. I would like to thank Nicola de Giorgi, Fabio Recine, Inigo Arruga Oleaga and Livio Stracca for their comments.

[2] See Louis (1995), Banking Supervision in the European Community: Institutional Aspects, Editions de l’Université de Bruxelles (Brussels); and T. Padoa Schioppa (2004), Regulating Finance: Balancing Freedom and Risk, Oxford, p.75.

The Treaty of Lisbon strengthens the ECB's position in several ways: i) it establishes the principle according to which the ECB is independent in the exercise of its powers; ii) explicit reference is made to the financial independence of the ECB; iii) the primacy of the objective of price stability for the Eurosystem, which is included as one of the Union's objectives, is confirmed, together with the (new) objective for an "economic and monetary union, whose currency is the euro"; iv) the ECB is recognised as an institution of the European Union, joining the Council of the European Union, the European Commission and the European Parliament, even though it has legal personality.

It can sometimes seem as through central banks are obsessed with the question of independence, which, now that it has been laid down in the Treaty, would appear to have been achieved. Yet, it is surprising how often, ten years after the start of Economic and Monetary Union, measures continue to be proposed at national level that in some way or another threaten the independence of the central banks, in particular, with respect to their functional, institutional, personal and financial independence.[3]

I refer to two very recent examples, concerning two countries – Italy and Germany – where draft legislation introduces measures that risk contravening the principle of independence established in the Treaty.

In Italy, the 2008 Financial Law, which was approved by the Parliament on 24 December 2007, provides for measures to reform the Banca d'Italia aimed at reviewing "in a general manner [its] means of financing, expenditure control, and payment of salaries and emoluments". These provisions do not take into account the (functional, institutional and legal) specificities of the Banca d'Italia, in particular, as a member of the Eurosystem, and therefore risk being contrary to the principle of independence.

In Germany, the draft law amending the Law on public employees, which would also apply to the Deutsche Bundesbank, risks undermining the functional independence of the German central bank, denying it the capacity to manage independently its legal and professional relations with its own employees.

The ECB will finalise its response to these two laws in the coming days.

The governance of the European economy is another aspect which has not been modified by the Treaty of Lisbon. Despite the ongoing debate and calls from several quarters to the contrary, economic policy remains substantially a national competence. However, it is true that the Treaty has introduced some changes to the economic governance of the euro area. Firstly, the roles played by the European Commission and the euro area countries have been strengthened in two ways. It provides for the capacity of euro area countries to adopt laws which reinforce the coordination and monitoring of budgetary discipline and which lay down specific economic policy guidelines. Furthermore, it falls to the euro area countries to adopt the Recommendation for another Member State to join the euro (until now this power was exercised by the European Council meeting comprising all of the Member States, rather than just the euro area countries). Moreover, the recognition of the Eurogroup as an informal group, and the extension of the mandate of its President to two and a half years both strengthen the governance of the euro.

However, the political will has not developed to achieve a high level of harmonisation or coordination of the economic policies, even if a few improvements have been made to the procedures for increased cooperation. In short, despite the occasional calls by some governments for the creation of a real and genuine "European governance" of the economy, economic policy (with the exception of monetary policy) has remained the preserve of

3 For more details, see L. Bini Smaghi (2008), "Central bank independence in the EU: from theory to practice", European Law Journal, forthcoming.

national governments or, at the most, a task that is performed by the Member States concurrently.

The Treaty of Lisbon recognises the principle of subsidiarity as a founding principle of the European Union, even though it does so as a counterweight to the principle of superiority of European law over national legislation. In essence, the principle of subsidiarity leads to a situation whereby legislative and regulatory autonomy are deemed “normal”. A high degree of coordination or complete harmonisation is only allowed if this leads to better results. The burden of proof weighs heavily on the side of harmonisation and centralisation.

2. Financial regulation and supervision

The European system of supervision and regulation is characterised by a combination of regulatory harmonisation and autonomy – and to some degree also of competition. No single Community body bears overall responsibility. The legal instruments typically used in this regard take the form of Directives rather than Regulations. This gives the national authorities considerable room for manoeuvre when transposing the Directives into national law.

The system of cooperation and coordination among the national authorities is based on a four-level approach known as the “Lamfalussy process”. To summarise, this consists of:

1. a few framework principles laid down in Community legislation (Level 1);
2. a series of technical implementing measures defined by the European Commission (Level 2);
3. a system of committees through which cooperation takes place among the national authorities for implementation of the legislation and convergence of supervisory practices (Level 3);
4. under Level 4, the European Commission is given the task of monitoring the application of European Law, with the help of the national authorities and the private sector.

Although this system has borne some fruit over recent years, the question remains whether financial market developments necessitate substantial improvements in the quality of the European regulatory set-up. There are at least four arguments that support this hypothesis.

First, there is no doubt that the banking and financial systems of the various countries continue to be diverse. However, the recent market turmoil has highlighted the vulnerability of various national systems to shocks originating elsewhere, underlining how, today, banking and financial activity knows no boundaries.

Second, until a few years ago, cross-border financial activity was somewhat limited, above all as far as retail banking services were concerned. The distortionary effects of the various national regulations did not seem to be overly pronounced. Recently, the process of financial integration within Europe, and in particular within the euro area, has accelerated significantly. We have seen a large number of cross-border mergers and acquisitions and today in Europe there is a group of large banks that operate in various countries of the EU.[4] Moreover, the recent market turmoil has shown that, in an integrated monetary system such as the euro, the monetary market can constitute a conduit for the transmission of financial shocks originating elsewhere. There is no longer any need for a cross-border structure for a country to be infected by an external shock.[5]

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[4] L. Bini Smaghi (2007), “Consolidamento bancario, innovazione e accesso al credito, CESIFIN, Florence, 10 December 2007, available at http://www.ecb.int/press/key/date/2007/html/sp071210.it.html.

[5] See also Bruegel (2007): “Coming of age: report on the euro area”, Bruegel Blueprint 4.

Third, although it is not in principle an optimal model of financial regulation, the recent market turbulence has revealed structural weaknesses in some supervisory systems. In particular, it has shown the need to ensure that the central banks, which are responsible for supplying the markets with liquidity, especially in emergency situations, have all the necessary information at their disposal in order to assess the capital adequacy and sound balance sheets of their counterparties. The ECB had drawn attention to this in the past.[6]

Finally, the supervisory authorities appear less protected than the central banks from external pressures, which aim to reduce their decision-making autonomy. The concept of independence, which has been developed for monetary policy, is however not easily extendable, merely via regulations, to the supervisory authorities. This, however, also applies to the problem of accountability.[7] In a financial market in which there is room for a certain degree of regulatory competition and in which the supervisory authorities have a mandate and a predominantly national system of accountability, there may be incentives to utilise the margins for manoeuvre that European legislation leaves for protectionist purposes. There may also be disincentives for a proper exchange of information, necessary in order to guarantee the stability of the market. The risk of harming the financial institutions of one's own country and of exposing them to possible acquisitions may discourage a timely transmission of the information to other authorities, especially in periods of financial turmoil.

In brief, the developments under way in the financial markets are causing two types of problem to emerge. First, the continual integration of markets increases the inefficiencies resulting from a variety of laws, or applied in different ways in different countries. Second, the possibility of applying the laws in various ways reduces the incentives for proper coordination between national supervisory authorities in respect of the prevention and resolution of crises.

The approach taken up to now to tackle these problems has been to strengthen the current institutional system (the Lamfalussy system). But much remains to be done. The ECB has recently published its proposals for improving the system, notably:

i) strengthening the role of the Committee of European Banking Supervisors (CEBS, a level 3 committee that brings together the banking supervisory authorities) in order to improve convergence and cooperation in supervisory activities. In particular, it is deemed necessary to reinforce the legal basis of the CEBS (that at present is a network of national authorities) and both its accountability and that of its members, in relation to cooperation and convergence in supervisory practices.

ii) a greater convergence of the laws, by means of a clearer distinction between level 1 principles and the implementing measures by the Commission at level 2 (to which more attention should have been paid in the "Capital Requirements Directive") and the elimination of those laws in the said directive that leave options and discretionary assessments to the national authorities.[8]

In my opinion, the reasons for justifying differences in legislation, and differences in the applications of European laws, are getting weaker by the day. Rapid progress is needed towards a single regulatory approach, applied in the same way throughout the single European market. This is what the market wants, what the banking and financial institutions

[6] See, for example, the speech by Jean-Claude Trichet at the Committee of European Securities Regulators (CESR) conference, "Europe's Single Market in Financial Services: under construction or fully integrated?", Paris, 6 December 2004; and at the EUROFI conference, "Achieving the Integration of European Financial Markets in a Global context", Brussels, 3 December 2007.

[7] L. Bini Smaghi (2006): "Independence and accountability of supervision in the European financial market", speech at conference entitled "Financial Regulation and Supervision in Europe", Milan, Università Bocconi, 9 March 2006; available at http://www.ecb.int/press/key/date/2006/html/sp060309.en.html.

[8] European Central Bank, "Contribution to the review of the Lamfalussy framework", 30 November 2007.

want and what their customers want. This is also necessary in order to remove the disincentives to closer cooperation between the national supervisory authorities.

3. Two examples

I would like to illustrate two examples of fields where it is necessary to progress quickly, also in the light of the recent financial turbulence: deposit insurance and management of liquidity risk.

Banks are typically among the financial intermediaries which, on the one hand, have liquid liabilities and, on the other hand, illiquid assets. Transformation of liquidity is part of their raison d'être. However, it is also the basis of their vulnerability. Doubts felt by creditors, particularly by depositors, about the quality of the bank's assets (whether justified or not), can lead to a hasty withdrawal of the liquid liabilities of the bank and therefore to its insolvency (bank run). In order to prevent this scenario, the authorities have provided for liquidity requirements (ex ante) and deposit insurance schemes (ex post). The latter also have, if not above all, a consumer protection function.

In Europe deposit insurance schemes are still very diverse. The relevant Directive only calls for minimal harmonisation.[9] Such diversity can complicate the resolution of crises. It has to be noted, however, that there are no harmonised procedures to follow in the case of a banking crisis. In some countries the general law is applied to insolvency and there are no specific procedures for the failure of a banking enterprise as such; while in others countries (such as ours) there are appropriate procedures. The European Commission is studying a review of the Directive on the reorganisation and winding up of credit institutions.[10]

It is interesting to note how the funding difficulties of the British bank Northern Rock have forced the UK Treasury, the Bank of England and the Financial Services Authority to review some fundamental aspects of the regulatory framework for managing banking crises. As Mervyn King, Governor of the Bank of England, has also observed, the Northern Rock crisis has highlighted the need to reform the system of banking supervision in order to include (i) a special insolvency regime for banks, (ii) a credible deposit insurance scheme with sufficient cover able to refund depositors quickly. These remarks may be useful for reflection at community level.

Another example of the impact of the legislative divergence on financial stability concerns legislation on liquidity risks, which is not harmonised at European level and is applied non-uniformly to cross-border bank groups internally, at the very time when banking activity, in terms of stability and profitability, depends increasingly on the flow of liquid financial instruments between the various countries. The legislative discrepancy prevents an efficient cross-border use of collateral. This applies in particular to securitised credits and bank loans in general, which are not covered by the specific Directive.[11] Even though problems of this kind have not yet emerged, these conflicts could hinder the good functioning of the money markets and interventions by the central banks to restore appropriate liquidity conditions.

Faster progress is needed towards a single law at European level, at least as far as deposits insurance and liquidity management are concerned.

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[9] Directive 1994/19/EC.

[10] Directive 2001/24/EC.

[11] Directive 2002/47/EC.

Conclusions

In conclusion, the European institutional framework continues to be based on a fundamental asymmetry, with a single monetary policy and decentralised systems of supervision and financial regulation, subject to coordination that has increased over time but must be strengthened. If full advantage is to be taken of the economies of scale of the Single Market, also in the banking and financial sector, of which it forms the backbone, it is necessary to reinforce the common bases of European legislation, in order to ensure at the same time the development and stability of the market.

The progress achieved so far in this field is undeniable. But it is also undeniable that this progress is still insufficient to meet the demands for stability and efficiency in Europe's financial market. Experience shows that in times of relative stability it is very difficult to put into effect regulatory reforms of supervisory systems. Institutional changes often take place after turbulence and financial crises. However, experience also shows that hasty changes made under the pressure of an emergency are not always the best.

In my opinion, it is possible and necessary to work inside the current system to adopt, in reasonable times, a common rulebook at European level which constitutes a clear point of reference for financial institutions when performing cross-border services and which is applied uniformly by the national authorities. If sufficient progress were not to be made within the current system, the trends under way in the markets could determine a situation in which the only alternative, in order to safeguard the integration and stability of the market, would be a radical review of the European institutional framework in favour of a greater concentration of powers.

It is in the interest of those who prefer a decentralised – but coordinated – approach to supervision that rapid progress is made towards the harmonisation of European legislation on financial affairs.