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To What Extent Did Financial Regulation and Supervision Fail in Preventing The Crisis?

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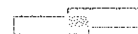
SUMMARY: 1. Introduction. – 2. Financial crisis and institutional failures: few remarks. – 3. Home country control and colleges of supervisors: outdated tools in a new scenario? – 4. Inefficiencies in crisis management. – 5. An incomplete list of regulatory and supervisory failures and of the relevant remedial actions in the regulatory agenda – a) Insufficient regulatory inclusiveness – b) A pure micro-prudential supervision does not warrant financial stability – c) Where micro-prudential and other regulatory measures proved an element of instability – d) Liquidity (mis)management – e) Diverging supervisory styles and the supervisory competition in laxity – f) The lack of a supranational approach to crisis management and resolution.

1. *Introduction.* – The crisis was not simply a question of major, and certainly existing, "market failures" but also a dramatic consequence of deep "institutional (government) failures". This paper endeavours to offer a brief overview of these macro- and micro-prudential inefficiencies, which prevented from averting first, and properly managing then, the recent financial crisis. It considers some exemplary issues: (i) inadequate regulatory inclusiveness, (ii) insufficient macro prudential supervision; (iii) micro-prudential regulatory and supervisory ineffectiveness (and, sometimes, blindness) and, in some instances, its even counterproductive role (when regulation worked as a pro cyclical engine or induced negative "herd" behaviour); (iv) fragmented and insufficient regulation and supervision of liquidity management; (v) diverging supervisory styles; (vi) lack of common rules and practices on cross border crisis management and resolution. All these inefficiencies are viewed as the inevitable output of a regulatory and supervisory competition "in laxity" due to two perverse incentives: (a) there is a negative correlation between regulation and strict supervision, on one hand, and profitability of the financial industry, on the other hand, and (b) despite harmonization efforts, lacking a pan-European regulatory and supervisory dimension for cross border groups, Member States are left to compete to attract the financial industry from neighbouring States. Drawing lessons from the existing insufficient cooperation among national regulators and supervisors (herein included colleges of supervisors), I call for a significant institutional re-design, conferring a stronger regulatory and supervisory role to pan-European institutions.

2. *Financial crisis and institutional failures: few remarks.* – Since the entry into force of the Treaty of Maastricht, the dimensional and functional asymmetry between global markets and cross border financial conglomerates, on one side, and national supervisors, on the other side, increased dramatically. Suffice to mention that, following the cross border expansion and consolidation of the European banking and financial industry in recent years, a small number (compared to the total number of more than 8,000 banks in the EU) multi-jurisdictional banks and financial conglomerates account for a disproportionate share of total assets (note that already in 2003 the top-50 EU banks accounted for more than 60% of total assets of all EU banks). The same holds true also in the American and global markets. Unfortunately, despite the very many international and European efforts made in the last decade or so towards regulatory and supervisory harmonization and convergence, these big players – which have become no only "too big to fail" but also "too big to manage" and, ironically, even "too big to save" (for a single MS) – are still subject, in Europe and globally, to diverging regulatory standards and to uneven supervision. This proved very inefficient in averting first, and then manage, the crisis. The crisis was therefore not simply a question of major (and certainly existing) "market failures" but also a dramatic consequence of deep "institutional (government) failures". This is, nowadays, widely recognized: suffice to mention, in Europe, the results of the De Larosière Report [1] and of the Turner Report [2] Inefficiencies were (and are) both micro- and macro-prudential.

a) Micro-prudential inefficiencies from the regulator and supervisor side stem from a well recognized conflict of interest among national regulators and supervisors. As it has been correctly noted "in addition to contributing to the stability of their financial system, supervisory authorities have an implicit – and sometimes explicit – task, that of defending and promoting their national industry within an integrated international financial market. To some extent, this puts supervisory authorities in competition among themselves, which affects their regulatory and oversight tasks" [3]. This conflict of interest fosters a strong regulatory and supervisory competition in laxity, since there is a negative correlation between regulation (and strict supervision) and profitability. "We know by now that those sectors of the financial markets that are less regulated are also more prone to be risk taker and thus more profitable at least in certain periods. There is a clear incentive for market participants to have less regulation". Due to the international dimension of finance and to the rapid mobility of products and factors of production in this sector, "in such a context there is an incentive to reduce the level of regulation (and strict supervision) compared to other countries in order to attract the financial industry from neighbours. Given the high value added that financial industry generates and the negative correlation between regulation and profitability, the incentive to compete on regulatory standard is much stronger than in other sectors, especially for countries which have put the financial sector at the centre of their economic policy priorities". History repeats itself: indeed, this was also the way the American dual banking system has been working since 1864 [4]. In addition to that, a ECB study of 2004 [5] finds that, since the costs and



[1] The High Level Group on Financial Supervision in the EU, *Report*, 25 February 2009, passim, especially at chapter III.

[2] FSA, *The Turner Review, A regulatory Response*, March 2009, 86 ff. (see also p. 36 where the lessons drawn from the Landsbanki collapse).

[3] BINI SMAGHI, *A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market"*, paper presented at the CFM-IMF Conference in Frankfurt am Main, 26 September 2008, p. 2.

[4] WHITE, *The Regulation and Reform of the American Banking System, 1900-1929* (Princeton University Press, 1983), *passim*

benefits of closing a multi-jurisdictional bank usually differ across countries (either due to different activity or size of activity in the two countries, to different systemic importance of the bank in the two countries or to the pressure exerted by the institutional environment), supervisors preferences for closure do not coincide and the host country supervisor may have incentives to misreport its private (soft) information to the home country supervisory authority in order to obtain a preferable outcome. The same could probably be said also the other way round in respect to the evaluation of the information made by the home country supervisor. This indicates that joint welfare depends negatively on the supervisors' divergence of interest and that, when supervisors' preferences are not aligned, a first best decision can never be reached. This is an important finding in respect to the (very little) benefits which can be rationally expected by bilateral or multi-lateral Memoranda of Understandings for international banking and financial supervision if compared to a more rational and effective centralised global or at least pan-European supervision.

b) Micro-prudential inefficiencies from the side of international banks brought about by regulatory fragmentation are, in turn, well known. The industry is confronted with a multitude of supervisory authorities (Professor Wymeersch counted, a few years ago, up to 54 financial supervisors in Europe[6]) and different, albeit partially harmonized, national requirements. Explicit or implicit national discretions left open by the directives (a very illustrative example was the original CRD, which left open more than hundred options to national preferences), gold-plating and diverging national interpretation make it not only very difficult and sometimes impossible for an international bank to adopt a cost-efficient single compliance strategy within the EU but also more vulnerable cross border groups to crisis. Consider internal risk models: sometimes multi-jurisdictional banks are induced to use locally the "standard model" instead of the advanced model used by the parent company and by the group elsewhere simply because of the reluctance of local supervisors to accept the methodologies approved by other supervisors. Other examples are: (i) reporting: so far, CEBs issued in 2005 guidelines for common practice and promoted an agreement to deliver "a single reporting standard" by 2012; each national supervisor, however, has still many specific requirements for prudential reporting in place, regardless of the rules at the consolidated level; a situation which only the long awaited "single rule book" envisaged by the proposals on the new European Authorities is expected to finally settle; (ii) asset transferability: this proved almost impossible when urgently needed for liquidity constrained cross border financial groups.

c) Macro-prudential inefficiencies both in the gathering and pooling of all relevant soft information on cross border systemic stability and in its assessment and processing played also a major role in the failure in preventing the crisis. As big European banks have grown in prominence and wholesale markets have become closely integrated, problems at the level of individual big banks are more likely to have systemic effects[7]. "Consequently – it has been

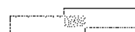
[5] HOLTHAUSEN-RONDE, "Cooperation in International Banking Supervision", *ECB Working paper* Series, no. 316, March 2004, passim

[6] WYMEERSCH, "The structure of financial supervision", available at *ssrn 946695*

[7] Compare ALEXANDER-EATWELL-PERSAUD-REOCH, *Financial Supervision and Crisis Management in the EU*, a study commissioned by the EP Policy Department, Brussels, December 2007 (IP/A/ECON/IC/2007-069), passim, complaining that there has been a failure up to now to incorporate systemic risk into the design of regulatory institutions.

rightly said[8] – it is difficult to draw a line, in practice, between the responsibility for systemic stability, including the function of lender of last resort and that of prudential supervision of large banks. Indeed, in today's increasingly market based financial system, disturbances are likely to affect core market mechanisms". Nonetheless, even in the Euro area, micro-prudential supervisors did not cooperate on data pooling with each others and with the ECB and did not accept to receive from the ECB any policy recommendation on the priorities of micro-prudential supervision derived from ECB internal macro-prudential assessments. This has important implications. Lacking a clear allocation of responsibility among supervisors and a strong interaction between macro- and micro-prudential supervisors, there are huge risks of informational asymmetries and opportunistic behaviours. First, as it has been correctly noted, "recent experience has shown that conflict of interest hampers the necessary transmission of information on critical institutions from the supervisory authority to the central bank, even within the same country, in the hope that weak institutions would be bailed out by liquidity injections rather than by addressing the solvency problem. This makes contagion from individual institutions to the rest of the market more difficult to avoid"[9]. This is to say that, in the current situation, where central banking and banking and financial supervision (be it vertically segmented or centralised in a single body, depending on the very many organizational models adopted from country to country) are split at national level, strict and timely informational cooperation failed; and it was so despite the very fact that "for the execution of central bank functions, timely access to micro-prudential information on individual banks is relevant. In the financial turbulence, information on the liquidity arrangements of counterparties, their sources of funding and of their financial position has proven to be essential to obtain a clearer picture of the liquidity pressures influencing banks". Second, in case of crisis authorities have an incentive to push the burden of adjustment towards other foreign institutions (activating e.g. host MS central banks as lenders of last resort or foreign deposit insurance schemes for subsidiaries) or to advocate the use of inflation tax to help out weak banks so to spread out the costs to all taxpayers of the Union rather than to only those of the country of origin, who however reaped all the fruits in good times.

3. ***Home country control and colleges of supervisors: outdated tools in a new scenario?*** – Against this backdrop the European regulatory and supervisory reliance, so far, solely on home country control and "voluntary" cooperation among supervisors in the banking and financial supervision of cross border groups has become, in my view, highly questionable[10]. It is, for sure, a second best if compared to the first best solution (which I advocate without any hesitation) of a pan European supervision for cross border financial players assigned to a central European authority, allowed to exercise some of its function through delegation of tasks to national authorities: an institutional reform which, however, was unfortunately only timidly advanced (as a mere option for the future) by the Commission and was then dropped and cancelled from the draft regulations on the new European supervisory authorities by the Council at first reading. And, to my mind, this is an issue to which the



[8] WELLINK, *Banking supervision in Europe: Developments and challenges*, speech held at the 36th Economics Conference 2008, Austrian National Bank, Vienna, 28 April 2008, 3.

[9] BINI SMAGHI, *A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market*, 2.

[10] For a similar finding, compare also BEGG, "Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis", *JCMS*, 2009, 1107-1128.

European Parliament should devote great attention (so as to return at least to the original Commission's proposal).

Not surprisingly, lacking a central European supervisory authority, the current allocation of regulatory and supervisory powers on cross border groups is contended also by those who do not advocate a pan European solution. Drawing lessons from the uneven burden sharing implied in some cross border bail outs, some [11] argued that also systemically relevant branches should be exempted from the home country control and left (as it is currently the case for subsidiaries) to the supervision of the host MS which, in case of distress, is in practice called to intervene.

Others contended, to the opposite, that home country control should be extended also to foreign subsidiaries – currently regulated and supervised by the MS of incorporation – allocating all supervisory powers on the cross border banking and financial groups at consolidated level to the parent company supervisor, provided however that new European rules are enacted to allow integrated group management, asset transferability within the group and to define *ex ante* a proper burden sharing between home and host Member States.

For sure, up to now, the experience of supervisory coordination, also through the colleges of supervisors, proved very ineffective. Although the new CRD sets out that "colleges of supervisors shall provide a framework for the consolidating supervisor and the other competent authorities concerned to carry out the following tasks: a) exchange information; b) agree on voluntary entrustment of tasks and delegation of responsibilities; c) determine supervisory examination programmes based on a risk assessment of the group; d) increase the efficiency of supervision by removing unnecessary duplication of supervisory requirements; e) consistently apply the prudential requirements under the Directive across all entities within a banking group; f) apply article 129(1)(c) taking into account the work of other forum that may be established in the area", the experience shows that there is no pan European common practice within the colleges. There are as many colleges as multi-jurisdictional groups: to my knowledge this means, today, 123 colleges: they are effective, within the framework of common guidelines recommended by CEBs, in the data pooling and the exchange of information but they did not deliver so far a uniform and centralised supervision and supervisory style. Their number increases the coordination problem [12] and, to my mind, cannot bring about a truly level playing field for cross border supervision, until a uniform implementation of the supervisory functions by all the colleges is achieved. A difficult, or rather impossible, task essentially delegated now to the EBA. Not surprisingly, the lack of effective pan-European coordination among supervisors played a major role in preventing the supervisors to timely detect first, and then to properly and jointly react to the market failures originating the crisis.

4. *Inefficiencies in crisis management.* – Things were (and are) even worst in the cross border crisis management. Indeed, it is widely accepted that the crisis has shown: (i) the devastating effects for host countries from decisions taken on a solo basis by home country authorities (the Icelandic example is very illustrative in this respect); (ii) the inefficiency of

[11] See Turner Review, p. 36 and 96-102; compare also BRUNNERMEIER-CROCKETT-GOODHART-PERSAUD-SHIN, "The Fundamental Principles of Financial Regulation", *The Geneva Report, ICMB-CEPR studies*, London, 2009, passim.

[12] A problem raised also by the industry, complaining that «practices concerning formation and activities of banking supervisory colleges are extremely divergent»: see EFR, *Monitoring Progress in EU Prudential Supervision*, 42.

remedial action taken essentially at national level (suffice to make here two examples: on one hand, the Fortis resolution plan, which required that the group be split along national lines in order to be re-nationalised and its bail out funded out of national budgets; on the other hand the emergence of the "too big to save" paradox, when small countries suddenly realized they were unable to deal with the bail out costs of large cross border banks established in their territory); (iii) the inefficiency of the national corporate and insolvency laws to deal with cross border liquidity or solvency crisis (asset transferability, especially in times of crisis, becomes a tricky exercise in an institutional environment characterized by fragmented corporate and insolvency laws and lacking common rules on integrated banking groups). Ring fencing is also a function of such regulatory inefficiencies in the field of "common" corporate and insolvency law.

To all that it should be added that, to address emergency situations and in particular cross border crises which may potentially jeopardise the stability of the financial system in any of the home or host Member States, most of the EU coordination action is still based on the non legally binding provisions of MoU, and now in particular on the "soft law" provisions of the Memorandum/a of Understanding (MoU) on cooperation between the financial supervisory authorities, central banks and finance ministries of the EU on cross border financial stability. The standard MoU fosters the establishment of Domestic Standing Groups and Cross-Border Stability Groups for national and international banking groups respectively whose activity should be guided by Voluntary Specific Cooperation Agreements. As regards the appointment of the lead supervisor, the MoU sets out that, "as a rule the National Coordinator of the home country assumes the task of Cross border Coordinator in the management of a cross border financial crisis" but at the same time that "it may delegate tasks to authorities in a host country". The Party assuming the role of coordinator may vary according to the nature and the stage of the crisis, and namely in a liquidity crisis with a potential for systemic implications the Central Bank of the home country will coordinate actions whereas in a solvency crisis with a potential for systemic implications which may imply the use of public funds, the Finance Ministry in the home country will coordinate the process of deciding on whether, to what extent and how public funds will be used. In this connection, Member States should agree in advance "on burden sharing based on equitable and balanced criteria". However, "as the provisions of this Memorandum are not legally binding on the Parties, they may not give rise to any legal claim on behalf of any Party or third parties in the course of their practical implementation": in legal terms this means that these provisions are not legal norms but social norms. A code of good manners for supervisors, so to say, at least so long as detailed and specific burden sharing agreements between Member States are not agreed upon (a result whose achievement seems to be very far apart, considering the emphasis currently put by some Member States to their fiscal responsibility) and made internationally binding by the Member States concerned. It is hard to believe that in difficult times good manners may suffice to counterbalance very robust incentives to cheat, as those naturally at work. Even more so when cheating may help in shifting the fiscal costs of banking bail out to other communities.

5. ***An incomplete list of regulatory and supervisory failures and of the relevant remedial actions in the regulatory agenda.*** – As it has been correctly noted "many believe that the major cause of the recent crisis was excessive risk taking by market participants due to perverse incentives, pervasive conflict of interest and inaccurate measures of financial risk exposures". Regulators and supervisors proved however unable "to contain the build up of the risks across the financial system and this inability stemmed from an excessive prudential focus on individual financial institutions, inadequate tools for analysing systemic risks and gaps in

supervisory information and in the regulatory perimeter"[13]. Many blamed also an expansive monetary policy in the past decade: but, at least according to the findings recently offered by Ben Bernanke[14], "the response to the housing bubble would have been regulatory, not monetary. Stronger regulation and supervision aimed at problems with underwriting practices and lenders' risk management would have been a more effective and surgical approach to constraining the housing bubble than a general increase in interest rates. Moreover regulators, supervisors, and the private sector could have more effectively addressed building risk concentrations and inadequate risk management practices without necessarily having had to make a judgement about the sustainability of house price increase".

It is obviously not possible to offer a comprehensive list of regulatory and supervisory failures and/or discrepancies among MS which affected (and still, at least partly, affects) the "institutional" responsiveness in preventing financial crises. A few examples could however be of help.

a) *Insufficient regulatory inclusiveness*

Regulation and supervision was tardy in responding to market developments regarding the nature and activities of financial intermediaries. In other terms, micro and macro prudential regulation and supervision were not properly designed, e.g. to encompass and include "quasi banks", like non bank providers of payment services, investment banks, hedge and other alternative investment funds, and alike. A "shadow banking sector" was thus left open to the excessive complacency of mere self-regulation and/or to regulatory and supervisory arbitrage. The legislative history of off shore and European in shore hedge funds, and their "differential" (private and public) regulation and supervision (lacking for instance mandatory provisions on leverage) is very illustrative in this respect[15]. To fix this problem, scholars[16] and policy makers recommend now to subject to prudential supervision any firm which meets either of the following criteria: (i) it provides payment services; (ii) it predominantly holds or guarantee risky financial assets and funds these holdings with liquid debt liabilities that can be redeem at face value on short notice. It is pointed out that, following this criterion, "AIG, Fannie Mae, Freddie Mac, most investment banks and possibly General Electric Credit and the captive auto-finance companies would have been identified as banks".

The point is clearly made also by the Obama administration: as Secretary of State Timothy Geithner put it a few months ago[17] "the structure of the financial system has shifted, with dramatic growth in financial activity outside the traditional banking system, such as the market for asset backed securities. The administration's plan will impose robust reporting requirements on issuers of asset-backed securities; reduce investors' and regulators' reliance on credit rating agencies and perhaps most significantly, require the originator, sponsor or broker of a securitisation to retain a financial interest in its performance. The plan also calls for harmonizing the regulation of futures and securities, and for more robust safeguards of payment and settlement systems and strong oversight of "over the counter" derivatives".

[13] STEPHANOU, "Charting the Future of Financial Regulation", in *Crisis response*, Note no. 2, The World Bank, June 2009 (also available at ssrn.com/abstact#1427398)

[14] *Monetary Policy and the Housing Bubble*, presentation at the Annual Meeting of the American Economic Association, Atlanta, 3 January 2010, 20.

[15] Compare LAMANDINI, *Alternative investment vehicles (self-)regulation*, hearing brief, EP Legal Affairs Committee, 25 February 2008 (also available on the EP website).

[16] BOYD-JAGANNATHAN-KWAK, "What Caused the Current Financial Mess and What Can We Do About It?", *working paper*, 2009.

[17] "A New Financial Foundation", *The Washington Post*, June 15, 2009.

In turn, the European regulatory responses (either adopted or proposed, as the case may be) on hedge funds, clearing and settlement for other the counter derivatives, credit rating agencies and, through the CRD revision, on the "originate-to distribute" banking model (requiring now that the originator retains a percentage – unfortunately still too small to represent a real incentive to check properly the credit quality of its borrowers – of the asset backed securities originated by its loans) are initial attempts to draw a lesson from the "institutional failures" implicated by the crisis.

b) *A pure micro-prudential supervision does not warrant financial stability*

"A fundamental conclusion drawn from the recent financial crisis is that the supervision and regulation of financial firms in isolation – a purely micro-prudential perspective – are not sufficient to maintain financial stability" [18]. As the Geneva Report 2009 put it "we cannot make the system sure by making sure individual banks. It seems a truism but it is a fallacy of composition" [19]. In other terms, macro-economic insights were insufficiently used to shape the regulatory setting and to orient supervision. As it has been noted also by Bini Smaghi [20] "had there been a more integrated assessment of the impact of financial innovation, the risks developing in credit risk transfer markets would have been better understood and monitored. However the flow of information from the micro-prudential supervisors was insufficient to undertake such an assessment". This poses a question of institutional redesign, so as to coordinate effectively central banking and supervision. The latter has the information on market players and market conditions whilst the former has the analytical tools for assessing macroeconomic risks associated to financial market developments. Good examples of such a necessary interplay are the recently performed supervisory capital assessment programs (bank "stress tests"), where macro and micro-prudential perspectives have been joined to create a stronger supervisory framework [21]. It is however surprising that this had not be done so far. It remains, moreover, to be seen whether the new macro-prudential setting, once duly implemented, will be based on rules-based laddered triggers (based on objective parameters) or on the mere discretion of the relevant authorities.

c) *Where micro-prudential and other regulatory measures proved an element of instability.*

Micro prudential regulation in-avertedly became also an element of macro instability: on one hand, imposing for instance (with some of the Basle I and Basle II provisions) pro-cyclical requirements (which did not generate the crisis but contributed to the deepening of some of its financial effects) instead of imposing (as it should have been) counter-cyclical capital charges (to be imposed, e.g., when there is an above average growth of credit expansion and of leverage or a mismatch in maturity); on the other hand diminishing the heterogeneity of financial appetites by excessively standardising the short term investment behaviour (and horizon) of all major regulated entities. This brought about an undesired "herd effect", where all players were induced also by micro-prudential rules to act collectively in a way that, instead

[18] HIRTLE-SHUERMANN-STIROH, "Macroprudential Supervision of Financial Institutions: Lessons from the SCAP", *Federal Reserve Bank of New York, Staff Report.* No. 409, November 2009 (*http:// ssrn.com/Abstract#1515800*).

[19] BRUNNERMEIER-CROCKETT-GOODHART-PERSAUD-SHIN, "The Fundamental Principles of Financial Regulation", *Geneva Report*, 2009.

[20] BINI SMAGHI, "Going Forward: Regulation and Supervision after the Financial Turmoil", paper presented at Finlawmetrics 2009, Milan, 18-19 June 2009, 7 (also available at *ssrn.com/abstract#1424345*).

[21] For a detailed illustration see the authors indicated at note 16.

of re-distributing in a more efficient way the risks and investment opportunities, jeopardised the overall macro-economic stability (see e.g. massive assets sales under bust conditions).

Compulsory reliance on ratings for regulatory purposed proved, in turn, a micro-prudential mistake which – coupled with the lack of a proper regulation and supervision of transparency of the rating process and of an effective ban of conflict of interests for CRAs – contributed to the deepening of the "market failure" represented by the capture of the three big credit rating agencies (which in theory were intended to act as gatekeepers) by investment banks. Once rating became a repeated game managed by a handful of powerful investment banks, incentives for CRAs to cheat out weighted by far incentives to act properly. Supervisors did not take, however, any timely action to face this problem.

Accounting and financial reporting was also a major institutional failure especially with respect to: (i) inadequate loan loss provisioning standards and (ii) the insufficient clarity (and the consequent diverging interpretations and practices) of mandatory requirements on securitised assets' "derecognition" which, by contrast, should have set out a clear-cut and uniform rule imposing the consolidation of all "securitisation vehicles" and their relevant exposures in a situation where these off balance sheet exposures were only apparently beyond the banks' perimeter. The relevant question is now whether more transparency would have been enough or more supervisory activity would have been (and is) also needed in this respect. I am inclining to believe that the latter is true: given the complexity and size of financial statements issued by financial institutions, reliance solely on the ability of market participant to accurately process financial information seems to me a bit naïve.

d) Liquidity (mis)management.

Liquidity mismanagement was also (partly) due to regulatory and supervisory fragmentation. Indeed, more European supervisory convergence in the liquidity management was brought about only by the recent CRD revision and is still incomplete. The perverse effect of such misalignment became clear when liquidity constrained big banks originated huge spill over effects due to the cross border nature of their activities and led to systemic instability, putting even at risk the wise and sound central banking principle of strict separation between liquidity provision policy and monetary policy (charging monetary policy with additional objectives, such as providing exceptional and emergency liquidity support to ensure financial stability). The EU framework on prudential regulation in liquidity was up to the crisis vague and fragile. The host supervisor was (and is) in principle in charge of monitoring liquidity risks; this is so also for branches (as an exception to the home country control principle). To be sure, the first CRD required banks to address liquidity risk but did not go into details. CEBS found in 2007 that "while most national authorities have long established frameworks for supervising liquidity, there are at present no explicitly agreed guidelines within the EEA covering the supervision of liquidity"[22]. It also pointed out that there were significant differences in qualitative and quantitative requirements set by national supervisors. The CRD revision brought about important changes (in Annex V of the directive) intended to set in much greater detail the guiding principles for banks' liquidity management so as to ensure more supervisory convergence[23].

[22] CEBS, *Survey of the current regulatory frameworks adopted by the EEA regulators*, August 2007.

[23] It made clear, on one hand, that «adequate levels of liquidity buffers» and «robust strategies, policies, processes and systems» are expected in order to «identify, measure and manage liquidity risk over an appropriate set of time horizons, including intra-day» (it being understood that each bank shall adopt the strategies and processes proportionate to its complexity and exposure to risk, considering also the bank's systemic relevance in each Member State in which it carries on business). In addition, banks are requested to: (i) develop a system of limits and appropriate methodologies for «the

These general principles are now better detailed, for the EEA, in a wider set of recommendations issued by CEBS on 18 September 2008 (CEBS 2008 147). At present, the 30 CEBS recommendations are however only best practices for banks and "mere" supervisors' expectations on better liquidity management. They will certainly serve as an important tool of supervisory orientation and are likely to be adopted at national level as supervisory principles. However, it should be recalled that CEBS recommendation 29 does not grant (and, due to its very nature, cannot grant without a CRD provision) to the consolidating supervisor any decision making power in the colleges to set common requirements on liquidity management for cross border groups where national requirements or supervisory practices differ.

e) *Diverging supervisory styles and the supervisory competition in laxity*

A comprehensive study published by CEBS in March 2009[24] lists similarities and differences among EU banks supervisors. It is widely accepted that the "light touch" supervisory approach in financial supervision followed in Europe up to recent times especially by the FSA led to supervisory arbitrage in laxity. Many agree that this is one of the reasons why European supervisors failed in preventing the crisis. The European fragmentation of "supervisory styles" is witnessed by the co-existence, within the EU, of supervisory models based upon very different approaches: they range from the Spanish "permanent exam" to models based upon *ex post* exam (where supervision is grounded on data regularly reported by the banks), which in turn can follow either a heavy touch approach (as it is the case of Italy) or a light touch approach (as it was the case of the United Kingdom). Be as it may, as a matter of fact supervisors failed to properly and timely addressing issues like appropriate capital requirements for securitized and trading book exposures and there were also significant failures in the framework governing the relationship between financial institutions and their customers (mis-selling of subprime mortgages; mis-selling of complex structured products; Ponzi schemes etc.). It is possible that an inducement to complacency from the supervisory side came also from the practice, very common e.g. in the UK, of "sliding doors" between supervisors and industry in both staff recruiting and the selection of those vested with the ultimate decision making power. This practice, whilst contributing in theory to a better understanding of the industry from the supervisor, in practice led to the wakening of the control. This urges, on one hand, the question on how policymakers can effectively promote the resurgence of a class of independent and skilled civil servants sufficiently motivated (and resourced) to permanently act as guardians of the general interest[25]. On the other hand, since regulation and supervision can be seen as an endless and unfair game of action and response where "the regulated side is

identification, measurement, management and monitoring of funding positions»; (ii) to distinguish between pledged and unencumbered assets in their liquidity management; (iii) to consider different liquidity risk mitigation tools, including liquidity buffers and an adequately diversified funding structure and access to funding sources; (iv) to consider alternative scenarios in their liquidity management; (v) to consider the potential impact of institution-specific, market-wide of combined alternative scenarios in different time horizons and under varying degrees of stress; v) to have in place and to test regularly contingency plans to address possible liquidity shortfalls. In turn, and consistently, Annex XI is also amended to subject these new management requirements to the supervision of competent authorities and to spell out in detail, under new point 1a, that supervisors «shall regularly carry out a comprehensive assessment of the overall liquidity risk management and promote the development of sound internal methodologies». In so doing, they «shall have regard to the role played by the bank in the financial markets and to the potential impact of their decisions on the stability of the financial system in all other Member States».

[24] CEBS, *Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers*, March 2009.

[25] Compare also PADOA SCHIOPPA, *The Crisis in Perspective: The Cost of Being Quiet*, in *International Finance*, 2008, 311-325.

able to move more often and more quickly than the regulatory side can"[26], it remains quite obscure how cross border supervision can become robust and dynamic enough so as to anticipate and neutralise opportunistic private rent extraction from global players if supervisors – lacking a global or at least pan European dimension – are nationally biased and permanently confronted with a race to the bottom even within their circle.

f) *The lack of a supranational approach to crisis management and resolution.*

The crisis made clear, in both sides of the Atlantic, that neither the US federal government nor the European institutions had the tools they needed to contain and manage cross border financial crises. This proved a major regulatory and supervisory failure. The lesson to be drawn by the crisis in this respect is that, to bring about an orderly resolution mechanism for both liquidity and solvency crises with systemically relevant impact of cross border groups, it is necessary and urgent to have in place European common rules on financial cross border group management, asset transferability and centralised insolvency proceedings. Fragmented national requirements not only make it difficult and ineffective to manage cross border financial groups in good times, but also irrationally insulate different parts of such integrated financial groups in hard times, giving rise to ring fencing and preventing a timely and proper management and resolution of the crisis. The recent consultative exercise launched by the Commission on asset transferability – challenging as it may seem on tricky corporate and insolvency issues related to the treatment of groups of companies – is therefore of major importance in the redesign of the European regulatory and supervisory framework. To my mind the European Parliament should call therefore for an acceleration of such process and should thoroughly consider all its relevant policy implications. Also in this respect it remains valid the old warning to policy makers attributed to Niccolò Machiavelli (and often voiced by many in the last few years[27]): "never waste a good crisis".

[26] CAPRIO, DEMIRGUC-KUNT, KANE, *The 2007 Meltdown in Structured Securitisation: Searching for Lessons not Scapegoats*, Paolo Baffi Centre on Central Banking and Financial Regulation, research paper series no. 2009-49, 5.

[27] BUITER, *Lessons from the global financial crisis for regulators and supervisors*, working paper, 13 June 2009, 1.