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**Towards a Regulatory Agenda for Banking in Europe**

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# **Towards a Regulatory Agenda for Banking in Europe**

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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 U.S. 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 “U.S. Shadow Financial Regulatory Committee”. In the meantime, similar shadow committees have been founded in Europe and Japan.*

*The specific problems associated with financial regulation in Europe, as well as the specific features which distinguish the European Shadow Financial Regulatory Committee from its counterparts in the U.S. 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 (ESFRC) 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:** Banking Regulation, EU-Directives, European Shadow Financial, Regulatory Committee, Convergences of Financial Systems

**JEL classification:** G15, G21, G28

## **I. Introduction and Overview**

Inspired by the example of the U.S. Shadow Financial Regulatory Committee (SFRC), the European Shadow Financial Regulatory Committee (ESFRC), as well as a similar Japanese body, were founded two years ago. All three 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, 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.

## **II. 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.<sup>1</sup> 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.

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

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.<sup>2</sup>

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 centralisation 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.<sup>3</sup> 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

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<sup>2</sup> On this point, see the instructive discussions presented in Herring and Litan (1995) and in Burghof and Rudolph (1996).

<sup>3</sup> With respect to the Basel Committee, this negative aspect of international co-operation between regulatory and supervisory agencies is discussed in detail by Herring und Litan (1995, pp.132 ff).

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.

### **III. The Origin, Composition, Objectives and Procedures of the ESFRC**

#### **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 U.S. Shadow Financial Regulatory Committee, which was itself modelled on the Shadow Open Market Committee.<sup>4</sup> The U.S. SFRC comprises many U.S. academics who have made important contributions to the literature on financial regulation.<sup>5</sup> The ESFRC follows the model of the U.S. 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 nonpolitical 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

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<sup>4</sup> Since 1973, this group has regularly issued assessments of U.S. monetary policy, and its statements have invariably attracted a great deal of attention in the press and in other media.

<sup>5</sup> The U.S. SFRC is currently chaired by George Kaufman, Loyola University, Chicago, and Robert Litan, the director of research at the Brookings Institution in Washington. Litan has produced a sizeable body of work on regulatory and supervisory issues; of greatest interest in the present context is the monograph on the international co-ordination of financial regulation which he co-authored with Richard Herring, who is also a member of the SFRC; cf. Herring and Litan (1995).

time. Currently, the ESFRC has 13 active members from 11 countries.<sup>6</sup> 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 U.S. 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 U.S. – 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 U.S. 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

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<sup>6</sup> The members are: Harald Benink, Erasmus University, Rotterdam; Christian de Boissieu, University of Paris I (Sorbonne); Franco Bruni, Bocconi University, Milan; Jordi Canals, IESE, Barcelona; Richard Dale, University of Southampton; Hans Geiger, University of Zurich; Friedrich Kübler, Johann Wolfgang Goethe University, Frankfurt/Main, and Clifford Chance; Karel Lannoo, Centre for European Policy Studies, Brussels; Rosa Lastra, University of London; Reinhard H. Schmidt, Johann Wolfgang Goethe University, Frankfurt/Main; Benn Steil, Council on Foreign Relations, New York; Niels Thygesen, University of Copenhagen; and Clas Wihlborg, University of Gothenburg.

influenced by this experience, the ESFRC has not adopted the fundamental point of view of the U.S. 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 U.S. 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.

## **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 patronising 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<sup>7</sup>

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<sup>7</sup> See, for example, Demirgüç-Kunt and Detragiache (1997) and Caprio (1997).

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.<sup>8</sup> 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 is 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

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<sup>8</sup> Cf. Basel Committee on Banking Supervision (1988, 1996, 1999a) and Deutsche Bundesbank (1998).

increase risk, or the insight that adherence to the “principle” that some banks are too big to fail has adverse consequences,<sup>9</sup> 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. Procedures**

The ESFRC meets on three weekends per year, 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.<sup>10</sup>

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.<sup>11</sup> Thus, it is essential to

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<sup>9</sup> For a discussion of these effects, see Bhattacharya et al. (1998), Burghof and Rudolph (1996, pp. 46 ff), Demirgüç-Kunt and Huizinga (1999), and Freixas and Rochet (1997, chapt. 9).

<sup>10</sup> 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.

<sup>11</sup> So far, interest on the part of the relevant newspapers and periodicals has been strong: among other publications,

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.<sup>12</sup>

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”.

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the *Financial Times*, *The Banker*, the *Frankfurter Allgemeine Zeitung* and the *Handelsblatt* have reported on the statements in detail.

<sup>12</sup> The statements are also published on the web site of the Brussels-based Centre for European Policy Studies: [www.ceps.be](http://www.ceps.be), click “research programmes”, and on the web site of the American Enterprise Institute: [www.aei.org](http://www.aei.org).

To date, one joint meeting with a subgroup of members from the U.S. and Japanese Shadow Financial Regulatory Committees has taken place. The statement which resulted from this meeting was one of the first comments on the new capital adequacy framework which the Basel Committee had issued only days before.<sup>13</sup>

#### **IV. The Statements of the ESFRC**

Since its founding meeting in Brussels in March 1998, the ESFRC has produced, issued and disseminated eight statements. All statements are similar in terms of their length and style. They are no more than five 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 eight statements are briefly summarised and certain common themes identified.

##### **1. Dealing with Problem Banks in Europe**<sup>14</sup>

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

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<sup>13</sup> 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 organisational structure and procedures: the group that met in New York ? which consisted of the U.S. 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 U.S. Shadow Committee, which provided a starting point for the group’s discussions.

<sup>14</sup> This is the title of the first statement issued at a meeting in London, June 1998.

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.

## **2. EMU, the ECB and Financial Supervision**<sup>15</sup>

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 decentralised 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

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<sup>15</sup> This is the title of the second statement issued at a meeting in Frankfurt, October 1998.

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.

### **3. Towards Safer Derivatives Markets<sup>16</sup>**

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.

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<sup>16</sup> This is the title of the third statement issued at a meeting in Paris, March 1999.

The European Shadow Committee drafted a series of recommendations which would make the OTC derivatives market safer. One of these 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. Improving the Basel Committee’s New Capital Adequacy Framework**<sup>17</sup>

The fourth statement issued by the ESFRC was drafted and published as a joint statement by members of the Shadow Committees of the U.S., 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 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.<sup>18</sup> 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

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<sup>17</sup> This is the title of the fourth statement of the ESFRC, which was prepared at a joint meeting of members of the U.S., Japanese, and European Shadow Committees (New York, June 1999).

<sup>18</sup> Cf. Basel Committee on Banking Supervision (1999b). 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 one 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.

capital requirement for an internationally active bank.<sup>19</sup> 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,<sup>20</sup> 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

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<sup>19</sup> 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.

<sup>20</sup> 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.

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 U.S. 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 riskiness 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.

## **5. A New Role for Deposit Insurance in Europe**<sup>21</sup>

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

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<sup>21</sup> This is the title of the fifth statement issued at a meeting in Milan, October 1999.

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.

## **6. Banking Mergers and Acquisitions in Europe**<sup>22</sup>

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.

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<sup>22</sup> This is the title of the sixth statement issued at a meeting in Brussels, February 2000.

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 anti-trust 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.

## **7. Internal Ratings Capital Standards and Subordinated Debt**<sup>23</sup>

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

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<sup>23</sup> This is the title of the seventh statement, which was also issued at the Brussels meeting in February 2000.

misrepresent information, and that bank supervisors would scarcely be in a position to prevent them from doing so. 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.

## **8. Towards a Single Market in European Securities Trading**<sup>24</sup>

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

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<sup>24</sup> This is the title of the eighth statement issued at a meeting in London, June 2000.

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 harmonisation 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 leaves 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 authorise 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.

## **9. 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 the 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.<sup>25</sup> 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.

## V. 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.<sup>26</sup> 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,<sup>27</sup> 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

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<sup>25</sup> This is also the position taken by Bhattacharya et al. (1998) and Boot and Thakor (1993).

<sup>26</sup> For an analysis of key structural differences between the financial systems of various countries, see Hackethal and Schmidt (2000).

<sup>27</sup> 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.

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' incentive 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.

The next joint meeting of the three Shadow Committees will be held in Tokyo in the autumn of 2000. Given the proposed topic – “Market Discipline in Different Parts of the World” – the meeting can be expected to produce highly interesting discussions, results and insights, not least because it will show whether the important differences in attitudes and approaches that undeniably exist between the U.S., Europe and Japan are so profound that they make it impossible for the participants to draft a meaningful joint statement and joint recommendations.

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