

THE MAASTRICHT CRITERIA FOR BANKING

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It does not happen very often that a select group of European Union leaders meet "en petit comité," outside the formal EU summits. Last week's gathering in London between the British, German, French and Italian leaders and the president of the European Commission was reminiscent of a similar crisis meeting that took place after the Sept. 11 terror attacks on the U.S. It illustrates just how seriously these governments take the current financial market gyrations. And rightly so: Too many European banks got caught in the U.S. subprime mess.

There are plenty of reasons why risk management in the financial sector should concern policy makers. News of the multibillion-euro losses that a rogue trader allegedly caused at Société Générale and the French bank's subprime exposure, which emerged only after the leaders had already planned their meeting, confirmed the oversight problems in the financial sector. These shortcomings could endanger the stability of the financial system and the savings of ordinary people.

It is natural, therefore, that EU governments would try to coordinate their response. But what can European policy makers really do? Would, as some are already implying, a more centralized oversight be a solution? Should governments strengthen enforcement? Should they enact new regulations?

As tempting as such a rush toward more and tighter regulation may be, it would hardly be successful. New EU laws -- and these issues are mostly dealt with at the European, if not global, level -- would not prevent the next crisis. European regulation already sufficiently addresses many of the problems that now plague the financial markets. There are already rules covering proper governance procedures and the necessity to diversify risk exposures and calibrate capital requirements.

If anything, the issue here seems to be more one of enforcement than regulation. But although the rules were certainly not properly applied in many banks, and risk controls obviously left much to be desired, it is doubtful whether stricter regulatory enforcement

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would really detect problems that even many bank managers only noticed when it was too late. Even in the U.S., where enforcement is much tighter and more centralized than in Europe, extensive on-site supervision of Citibank did not prevent write-downs at that bank of \$14 billion in the last quarter of 2007.

It is understandable that the policy makers who met last week in London want to be seen as "doing something" about the unfolding crisis. But they should not give the public the erroneous impression that they can really control the financial system. The underlying problem is largely one of perverse incentives in the banking sector. The consequences of banks' excessive risk-taking are often borne by the whole economy, as when the U.S. Federal Reserve cuts interest rates despite inflationary pressures.

A more integrated European oversight system would not have made much of a difference either. The banking problems that have caught the headlines over the last few months would not have been prevented if there had been a single European financial supervisory authority instead of the current multitude of national watchdogs. The banks that got burned in the U.S. housing market all come from countries with respected supervisory bodies. No doubt, there could be better coordination among European authorities, for example when it comes to the exchange of information or the delegation of responsibilities in cases of cross-border banking. EU finance ministers are discussing all these things. But it is difficult to say that progress on these issues would have prevented today's problems.

A more practical approach for Europe's regulators would be to benchmark sound bank-management practices, using a set of simple criteria that laymen can understand, and to continuously disclose this information. The difference to conventional rating agencies would be that these standards would be much more transparent and accessible to the public.

As with the Maastricht criteria, which set debt and deficit limits for public finances and seek balanced budgets in the medium term, European authorities should agree on a set of easily understandable standards to measure the quality of a bank's finances. These criteria must include liquidity, the regulatory capital requirement, the capital at risk (i.e., the degree to which banks expose their capital to risk), asset diversification ratios, and an index measuring good corporate governance.

European authorities should in each case set a minimum rate as well as a target rate -- a more ambitious standard to which banks should aspire in the long term. These targets should not be too difficult to calculate, as bank analysts commonly use them. Hence, a bank that uses depositors' funds for risky trading positions would have a higher cost of financing than a bank with a low risk profile, as other banks would be hesitant to lend to this bank and customers to deposit their savings there.

We should not expect immediate miracles from such benchmarks for sound banking. As with the Maastricht criteria, the effect would come over time. Customers would learn how to evaluate banks and have objective criteria at their disposal to choose the right financial institution for themselves. This should stimulate peer pressure and market discipline. It would lead to much more disclosure about sound banking than we have today.