

Financial Regulation

Worldwide regulatory developments and their implications for the financial services industry **international**

Europe

The weaknesses of the Eurosystem

Progress continues, albeit slowly, towards a pan-European equities market. One of the major steps to achieving this objective is cost effective and efficient cross-border clearing and settlement services. Consolidation of national central clearing and settlement services, either through acquisition or linkage cross-border, is seen as an important step to eradicate the inefficiencies and reduce the costs.

Pan-European equities business is subject to the jurisdiction of the relevant national securities regulation and regulators, as determined by the location of the transaction and regulatory regimes governing the parties to the transaction.

However, the securities settlement systems are regarded as embedded payment systems, since payment or receipt of currency is always one element of the transaction. Any major risks arising out of settlement of the monies give rise to possible systemic risk to the central money clearing systems and contagion to the currency. As such, they fall under the supervision of the relevant central bank, which has powers to protect the national currency. In the UK, for example, the Bank of England has specific powers to address systemic risk to money clearing systems.

This already has the potential to create complexities. For example, what would be the situation in the event that the private sector merged the clearing and settlement into one monopoly under a UK-based enterprise located in London and on the basis that the UK is still outside the euro? There would have to be at least two regulators for this institution: the Financial Services Authority (FSA) for the securities business and the clearing and settlement enterprise, the Bank of England in pounds sterling payments, but the European Central Bank (ECB) in respect of euro payments, as the Bank of England could not provide real time

collateral for euro risks.

Within the pan-European equities environment (within EU Member countries) oversight of the national currency of settlement is provided by the national central banks, in the instances of countries remaining outside the European Monetary Union (EMU). Currently, these are Denmark, Sweden and the UK and, until they join the European Monetary Union, the Accession States. In the Eurosystem respect of euros, this is the role of the ECB – or is it?

In contrast to the EU countries remaining outside the European Monetary System, the Eurosystem is a decentralised central banking system of the EMU. It is responsible for issuing the euro and for determining EMU monetary policy. The Eurosystem structure comprises both the ECB and the national central banks (NCBs). The ECB is not at the centre of the Eurosystem: it is not a powerful centralised monetary institution. The weaknesses of the ECB manifest the weaknesses of "a decentralised central banking system."

The ECB is not a bank of issue as it does not issue bank notes. It has no means of controlling the lending of euro notes brought into circulation by the NCBs as this is a monopoly of the NCBs. However, the NCBs are not entitled to set the interest rates for their refinancing operations nor determine the amount of central bank money to be allotted to their domestic commercial banks.

The Council of Governors of the Eurosystem sets the refinancing rate and determines the amount of central bank money to be allotted in the Eurosystem. The Council comprises 18 persons: six executive directors of the ECB and the 12 presidents of each NCB.

Repurchase agreements provide the overwhelming majority of the money lent to the financial sector; they are executed regularly each

week with a week's maturity. These are executed in a decentralised manner by the national central bank. The NCBs are similarly responsible for longer term refinancing operations of the euro monetary system.

More perplexing is the ECB's narrow remit. Maintenance of price stability is the prime objective of the ECB. Unlike central banks such as the Federal Reserve or the Bank of England, the ECB has no objective to maintain a stable financial and payments system and in consequence acting as a lender-of-last resort to financial markets and payment systems in order to protect the currency. Apart from other factors, the ECB lacks the size of balance sheet to conduct such activities.

Neither the NCBs nor the national governments are clearly responsible for responsibility for supervision of pan-European banks or for ensuring EMU-wide financial market stability. It must be assumed that the NCBs would step in to provide financial stability, but only to the extent that it may be necessary to protect their own financial systems and institutions. For the ECB to establish itself as "a lender of last resort" and to enable it to conduct these functions, it has to become a bank of issue.

The Euro-system's credit operations should be based on adequate collateral. Two classes of asset are described by the ECB as acceptable assets: Tier 1 and Tier 2, against which euro notes may be issued. Tier 1 assets cover marketable debt securities that are used across the euro area and are controlled by the ECB. Tier 2 assets comprise both marketable securities and non-marketable securities used in certain EMU countries, which are "deemed financially sound

exclusively by their NCB." In many instances these are issued by the public sector in the EMU state which accepts them and favours these entities by allowing them credit facilities with their NCB.

The role of the ECB in providing and maintaining a stable financial and payments system and, as a consequence of this, acting as a lender-of-last resort to financial markets and payment systems in order to protect the currency is at best uncertain. The role of the ECB appears to be one of intermediary between the Council of the Eurosystem and the NCBs.

Oversight of any central clearing and settlement system in terms of its embedded payment elements must be accompanied by certainty that it has the legal power and financial resource to take remedial action in the event that a crisis within the clearing and settlement systems may harm the euro currency. This is more fundamental than the operational and administrative initiatives to remove the barriers, which currently obstruct more efficient and lower cost for cross-border clearing and settlement within Europe.

Only a strong European Central Bank can ultimately eradicate the weaknesses of the Eurosystem and provide a permanent solution to the weaknesses inherent in "the decentralised central banking system" of the Eurozone. A strong central bank must have the powers of a bank of issue and be a bank that is able to work in concert and harmony with a strong centralised European treasury.

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