

# The Eurofi Financial Forum 2009

## Newsletter 1

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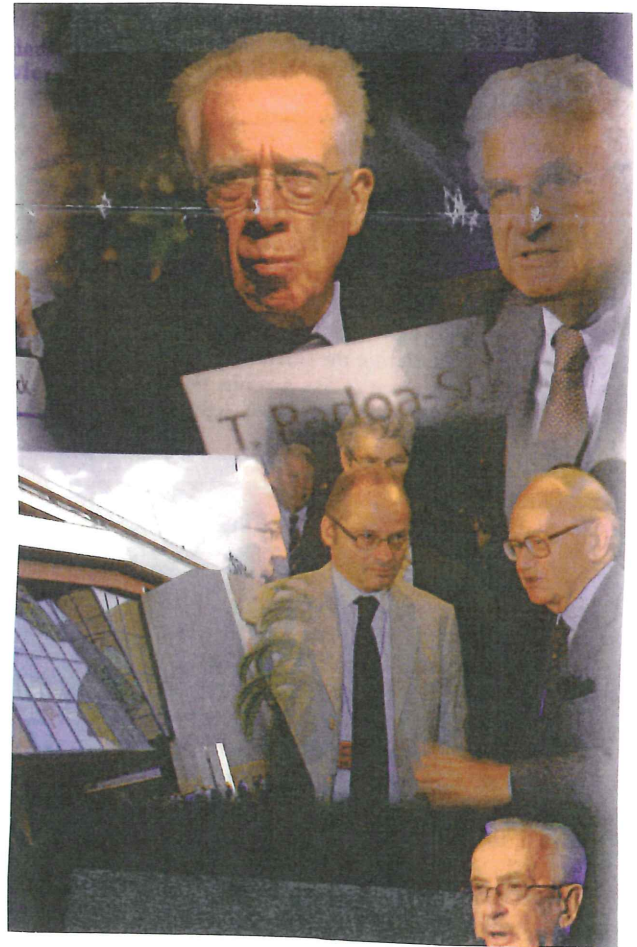


### Should governance of financial institutions evolve to compensate the increase of moral hazard?

The answer is: yes, but this is not the central point. Indeed, the reduction of moral hazard is primarily a public policy, not a business task.

Perverse incentives to imprudent financial behaviour are generated by regulators, supervisors, governments and Parliaments. Business does nothing more than responding to public incentives. In the recent crisis, particularly after the fall of Lehman, public authorities around the world have substantially increased moral hazard by letting the conviction implant that no other financial institution would be allowed to fail. They have thus made the system more fragile. To get rid of this negative legacy is a prime condition to reconstruct a healthy financial system based on sound market principle. To this end, new rules to manage the crisis of systemically relevant institutions have to be devised, and public authorities will have to persuade the markets and institutions that the new rules will be strictly observed. The way to succeed in this hard task is to distinguish much more clearly 'who' will be rescued and who not, in the event of a crisis. The minimization (total elimination is impossible) of moral hazard requires a credible threat that shareholders and managers will lose respectively their capital and their jobs; it does not postulate that all clients and employees will be fully penalized. If this is achieved, the governance of financial institutions will naturally evolve in a direction consistent with the new course of policy. ■

**TOMMASO PADOA-SCHIOPPA,**  
Chairman for Europe, Promontory Financial Group  
President, Notre Europe



### What are the key success factors to implement a consistent set of European financial rules?

To be implemented consistently, there is no other way than setting exactly the same rules across the EU. This condition is quite distant from the present reality and can only be fulfilled if an EU 'entity' is given full power to write and— in case of doubt - to interpret the rule book a financial

institution or group uses to be compliant vis-à-vis its regulator. The rule book should be literally identical in all countries, except for language. While it can be discussed whether the above entity should be a committee, an agency, the ECB, the ESCB, the Commission, or yet another institution, what must be assured is its ability to act even when its collegial decision making body (where national supervisors will sit) has divided views. The thousands of banking and financial institutions operating in the EU and in the euro area should continue to be supervised in a decentralized way by national authorities, which are close to them and possess a better understanding of the conditions and the environment in which they operate. Only for a limited number of plurinational financial groups, information will have to be pooled and decisions coordinated in order to manage systemic risk effectively. ■

**TOMMASO PADOA-SCHIOPPA,**  
Chairman for Europe, Promontory Financial Group President, Notre Europe