

## **Towards a new framework for EU financial supervision**

### Bullet Points for Commissioner's Intervention

- The current crisis has highlighted significant gaps in the framework for regulating and supervising the international financial system. This framework has failed to keep pace with the processes of integration and innovation in financial markets and so was ill-equipped to deal with the first truly global crisis of the modern era.
- In parallel with efforts to address these regulatory and supervisory gaps at the international level, President Barroso invited Jacques de Larosière to chair a high level group to review the scope for regulatory and supervisory reform in the EU. The members of this Group brought together a wealth of experience in the functioning of the financial sector and in the broader economy.
- As one might expect, the report of the de Larosiere Group (DLR) was a "tour de force". It begins by reviewing the main causes of the crisis. It pulls no punches in identifying where errors of judgement were made by financial market participants in both the private and public sectors. Such errors relate to:
  - Macroeconomic policy, where ample liquidity and low interest rates contributed to the accumulation of large

global imbalances, the mis-pricing of risk and large increases in leverage,

- Risk management by firms, supervisors, regulators and a lack of transparency, leading to the build up of a shadow banking system, the malfunctioning of the originate to distribute model and extreme complexity which few could understand;
  - The behaviour of credit rating agencies, where there were failures in the ratings of structured products and major conflicts of interests;
  - Corporate governance, where shareholder control of management was weak and remuneration schemes provided the wrong incentives;
  - The functioning of financial regulation and accounting rules, which resulting in adverse incentives and pro-cyclical market behaviour; and
  - Global institutional weakness, resulting in a lack of co-ordination in preventing and then managing the crisis.
- Having identified the problems, the DLR provides a comprehensive set of recommendations for remedial action in both the regulatory field. These recommendations include:

- The reform of Basel II to encourage a higher quality of capital, foster countercyclical bank behaviour, limit liquidity risk and apply stricter rules to off-balance sheet vehicles;
- The delivering Solvency II Directive so as to define appropriate safeguards to ensure an effective group support regime in the insurance sector;
- The registration of credit rating agencies, a review of their role in the financial system and the design of a distinct new approach to rating of securitized products;
- A strengthening in the governance of the International Accounting Standards Board, reflecting on the role of mark to market accounting necessary and improving valuation techniques;
- Regulation and supervision of the parallel banking system that has a potentially systemic nature, and in particular making information requirements on hedge funds mandatory through regulation of hedge fund managers;
- Standardising and simplifying derivative product, and creating at least one well-capitalized clearing house for credit default swaps in the EU;

- Strengthening rules on investment funds, including tighter control over depositories and custodians
  
- These recommendations for regulatory repair are delivered in a clear and comprehensible style and serve to reinforce similar messages from the Financial Stability Board. They also coincide with the ECOFIN roadmap for financial regulation in response to the crisis, which is now in the process of being implemented.
  
- The cutting edge in the DLR comes in the chapter dealing with supervisory repair – and this will be the main focus of today's conference. In this chapter of the report, the deficiencies in the current EU supervisory framework are clearly identified. We are left in no doubt about the need for reform nor about the need to make rapid progress in implementing reforms.
  
- There DLR vision of supervisory reform is based on two main elements. First, there is a need to reinforce the role of macro-prudential supervision. Macro-prudential supervision is a relatively recent concept and relates to financial-stability risks arising from macro-economic developments – such as excessive credit growth or asset price inflation – and broad developments within the financial system such as a concentration in mortgage lending or widespread exposure to complex and illiquid assets.

- Of the many lessons that we have learned from the ongoing crisis, one of the most important is the need to improve our understanding of this type of stability risk and how macro-prudential supervision should interact more effectively with micro-prudential supervision to prevent the build-up of financial imbalances.
- The DLR proposes that macro-prudential risk should be reinforced by the establishment of a European Systemic Risk Council. The ESRC would comprise mainly central bankers, reflecting their particular expertise in the field. However, it will be important that micro-prudential supervisors be involved to ensure that the perspective of the ESRC is properly balanced.
- You will not be surprised that I also believe that the Commission should be involved in the ESRC as the only institution with responsibilities for macro-financial surveillance at both the EU and Member-State levels.
- The primary role of the ESRC would be to assess the stability of the EU financial system. As risks emerge, it would be expected to issue timely warnings. These warnings would be followed by recommendations for action, with timelines for action.
- Of course, there is no point in receiving timely warnings and recommendations if we are not willing to act on them. Such recommendations may require difficult policy action in the

short-term but will help to safeguard financial stability and economic growth in the longer term. So, whether or not the ESRC is effective in its role will depend not on its structure or composition but on our willingness to make it work.

- While the ESRC would not have legally binding powers, it would have substantial "reputational capital". Recommendations would be issued on a "comply or explain" basis, so that failure to comply without adequate justification would have a cost.
- I cannot claim that a European Systemic Risk Council would have prevented the current crisis. However, I am sure that it would have allowed us to perceive the risk of crisis earlier and to understand its implications for the economic and financial system more clearly. So, in my view, the concept of a European Systemic Risk Council is beyond doubt.
- The second element of the DLR vision of a new framework for EU financial supervision is a European System of Financial Supervisors. The ESFS would build on the existing Lamfalussy arrangements, but would strengthen them in several ways.
- The ESFS would comprise three new Supervisory Authorities for the banking sector, the insurance and pensions sector and the securities markets. These Authorities would imply an upgrading of the current Level-3 Committees, providing them with a more formal structure and more binding powers.

- The new Authorities would have specific responsibility for promoting a more harmonised set of financial rules and a common supervisory culture. In this role, they could set common technical standards of supervision and act as mediators in the event of disputes between national supervisors.
  
- Again, I cannot claim that the existence of an ESFS would have avoided the current crisis. But, it would certainly respond to some of the weakness in the EU supervisory framework that have been exposed by the crisis. Despite the efforts that have been made over the years via the Lamafalussy Committees and the signing of MoUs, it is clear that the level of co-operation and information exchange among national supervisors fell short of what was necessary once the crisis struck.
  
- While we have been fortunate to have had only a few serious problems with cross-border financial institutions, the experience of supervisory co-operation in these cases has not been without problems. It is clear that we must do better in the future.
  
- Within the Commission, we are currently engaged in a process of internal reflection on the optimal structure and functioning of the ESRC and the ESFS. The outcome of this reflection will be included in the Commission Communication to the June European Council. This Communication will be published on

13 May and will reflect the input received from many sources during the public consultation that is underway since March. Similarly, I am sure that the Communication will draw inspiration from the proceedings of this conference.

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