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Towards a new supervisory architecture in Europe

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ENHANCING EUROPEAN SUPERVISION

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1. Summary and Introduction

This paper addresses the issue of enhancing European supervisory arrangements and institutions. The focus is on the need to introduce a specific macrosupervisory function and oversight.

Policy, regulatory and supervisory processes are inter-twined. Macro and micro supervision represent two distinct aspects of the overall supervisory framework. This holistic vision should not conceal the analytical and operational differences of the single functions, which can and should be examined separately.

The graphical analogy of a “diamond” is offered to highlight the novelty of this approach, as compared with the traditional “ladder” scheme of reference.

Macroprudential supervision can be seen as the centrepiece of a better regulatory and supervisory framework and of enhanced surveillance of macroeconomic policies. This is at the heart of the problem of ensuring financial stability, trust, and savers’ protection.

As indicated in the de Larosière Report, there are clear advantages in assigning this task to a new institution (ESRC), under the auspices of the ECB. There are instead important reasons why the microsupervisory role on large European cross-border banks cannot be given now to the Bank. Microprudential competences would instead be conferred, according to a step-by-step plan, to a European System of Financial Supervisors (ESFS), based on independent “Authorities” and on the network of national supervisors. The System should evolve, especially with a view to providing a sound response to crisis management and resolution.

This note – and I believe the de Larosière Report – is based on two related premises: (i) repair action in terms of regulation and supervision is urgent and (ii) the suggested financial changes should be as ambitious and as realistic as possible. This latter point inevitably requires consideration of legal constraints and instruments to enact proposed changes.

2. Policy, Regulatory and Supervisory Processes in Europe. The Lamfalussy vs. the de Larosière approach

The basic thrust of the analysis developed in the de Larosière Report is that policy, regulatory and supervisory processes are inter-twined but should be appropriately separated from an analytical and operational point of view. The interpretation of the main failures behind the crisis and the suggested course of repair hinge on this premise; the innovation of separating macro and micro prudential supervision allows to focus on the missing link of previous approaches: the need to identify and limit the distress of the financial system as a whole. Macroprudential corrective action may require suggesting and bringing forth changes in economic policies.

The fundamental underlying factors which made the crisis possible were: (i) ample liquidity creation; (ii) low interest rate conditions; (iii) global savings glut and excessive investment in housing notably in the US; (iv) the financing of large US current account deficits by emerging countries who pegged their currencies to the dollar, imported US monetary policy and accumulated large reserves, which fuelled further global monetary expansion.

In this process, macroprudential supervision was lacking, as well as multilateral surveillance on economic policies.

The lack of adequate macro-prudential oversight, on the one hand, resulted in inappropriate economic policies and ineffective identification of global risks, and, on the other, in regulatory weaknesses, and ineffective microprudential supervision. Key elements of regulation applied by microsupervisors thus played a negative role in fuelling the crisis. As is indicated in the chapter of the Report on Regulatory Repair, official regulation in some cases aggravated things, generated perverse effects and contributed to the excesses of securitisation.

A highly simplified, but I believe illuminating, way of presenting the fundamental change implicit in the de Larosière Report is contained in the following two slides.

The traditional approach is represented in terms of a “ladder” scheme (Slide 1) to the relationship between economic policy, regulation, and supervision.

In this hierarchical framework, economic policy is at the highest level, regulation follows, and enforcement of regulation is delegated to relevant supervisors.

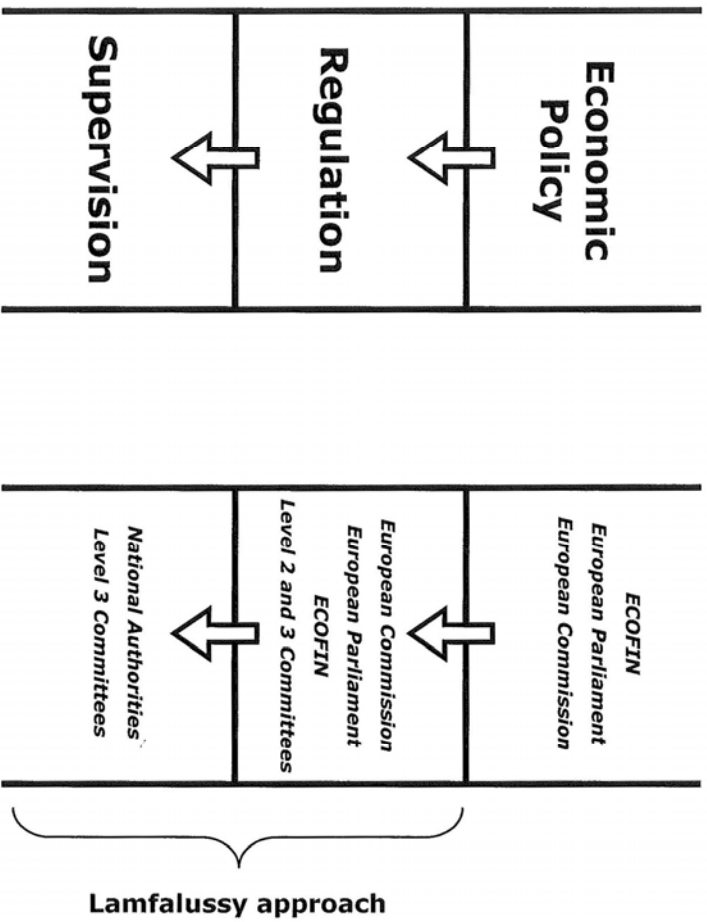
As will be noted, this scheme is behind the Lamfalussy process in Europe. Let it be stressed that the aim of the Lamfalussy Report in 2000 was to speed up the adoption of EU financial services law by providing a framework and mechanism for national, timely decision making based on open consultation, transparency and political accountability. The Lamfalussy process did not deal with strengthening prudential oversight – but the Report warned “while the committee strongly believes that large, deep liquid and innovative financial markets will result in substantial efficiency gains and will therefore bring individual benefits to European citizens, it also believes that greater efficiency does not necessarily go hand in hand with enhanced financial stability”.

In terms of the traditional process, National Governments (Parliaments) and the Ecofin decide economic policies, subject to European constraints.

EU regulation refers to the process of rule making and the legislation underlying the supervisory framework. The successive steps are:

- The Commission first adopts a formal proposal for a Directive/Regulation (Level 1), after which the European Parliament and the Council start negotiations with the aim to agree on the framework principles set out in the proposed Directive/Regulation and the definition of the related implementing powers;
- Once the Level 1 Directive/Regulation has been agreed upon by the European Parliament and the Council, the Commission consults the relevant Level 2 Committee (i.e. ESC, EBC, or EIOPC) and requests advice from the competent Level 3 Committee (i.e. CESR, CEBS, or CEIOPS) on technical implementation measures;
- Based on the advice received, the Commission prepares a proposal for a Level 2 Directive to be adopted through the comitology procedure (Level 2 Committee), setting up the implementing measures and launching the actual implementation into national law, and
- The Level 3 Committee finally works on: (i) day-to-day administrative guidelines, (ii) joint interpretation of recommendations and common standards, (iii) peer review, and (iv) comparisons of national regulatory practices so as to try to ensure consistent implementation and application of the agreed Directive/Regulation.

Traditional Ladder Approach



After the Directive/Regulation is implemented in national law, its enforcement is delegated to the relevant supervisor(s).

The subsequent supervisory process (monitoring the behaviour of firms, institutions, markets and market participants, licensing and chartering, and enforcing existing legislation) comprises the following elements (Lastra, 2006)¹:

- licensing, authorisation, or chartering of financial institutions, whereby the supervisor(s) check whether firms that want to enter the market fulfil the relevant criteria;
- the on-going monitoring of the health and conduct of financial institutions, based on the requirements set-out in the Directive/Regulation and the related technical measures. The relevant supervisor(s) may in particular examine the asset quality, capital adequacy, liquidity, management, internal controls, conduct of business and earnings;
- sanctioning or imposition of penalties in case of non-compliance with the Directives/Regulation, fraud, bad management, or other types of wrongdoing, and
- where needed, involvement in crisis management (usually in close cooperation with the Ministry of Finance and the Central Bank).

The nature of this traditional approach is thus basically top-down.

The de Larosière model is fundamentally different, and can be depicted as shown in Slide 2. The revolutionary element is indeed represented by macroprudential oversight. Macroprudential supervision is not confined to banks, but encompasses all sectors of finance, as well as the wider macroeconomic context. This oversight should also take account of global issues.

¹ Lastra, R. M. (2006), *Legal Foundations on International Monetary Stability*, Oxford University Press, Oxford.

While risks to the financial system can in principle arise from the failure of one financial institution alone, if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the more important systemic risk arises from a common exposure of many financial institutions to the same risk factors. That the financial system as a whole may be exposed to common risks has not been fully taken into account. Macroprudential analysis therefore must pay particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects.

More specifically, two main functions of macroprudential oversight should be underlined: (i) identifying systemically important components of the financial system (intermediaries, markets, securities, products, derivatives) and sources of systemic risk; (ii) deciding which form of regulation/supervision is appropriate to which institution/market. These two functions are intrinsically dynamic in nature.

Macro and Micro prudential supervision are both necessary and important. They are inter-twined in substance as well as in operational terms. But they should be clearly identified and kept logically separate: in the past microprudential supervision – i.e. overseeing and limiting the distress of individual financial institutions, and notably of banks – was at the centre of the attention. The role and function of macroprudential supervision must now be recognised and adequately dealt with.

As Slide 2 indicates, the diamond description and the arrows show that macroprudential supervision plays a key role, directly and in terms of interactions, not only with economic policy and microprudential action, but also with regulation.

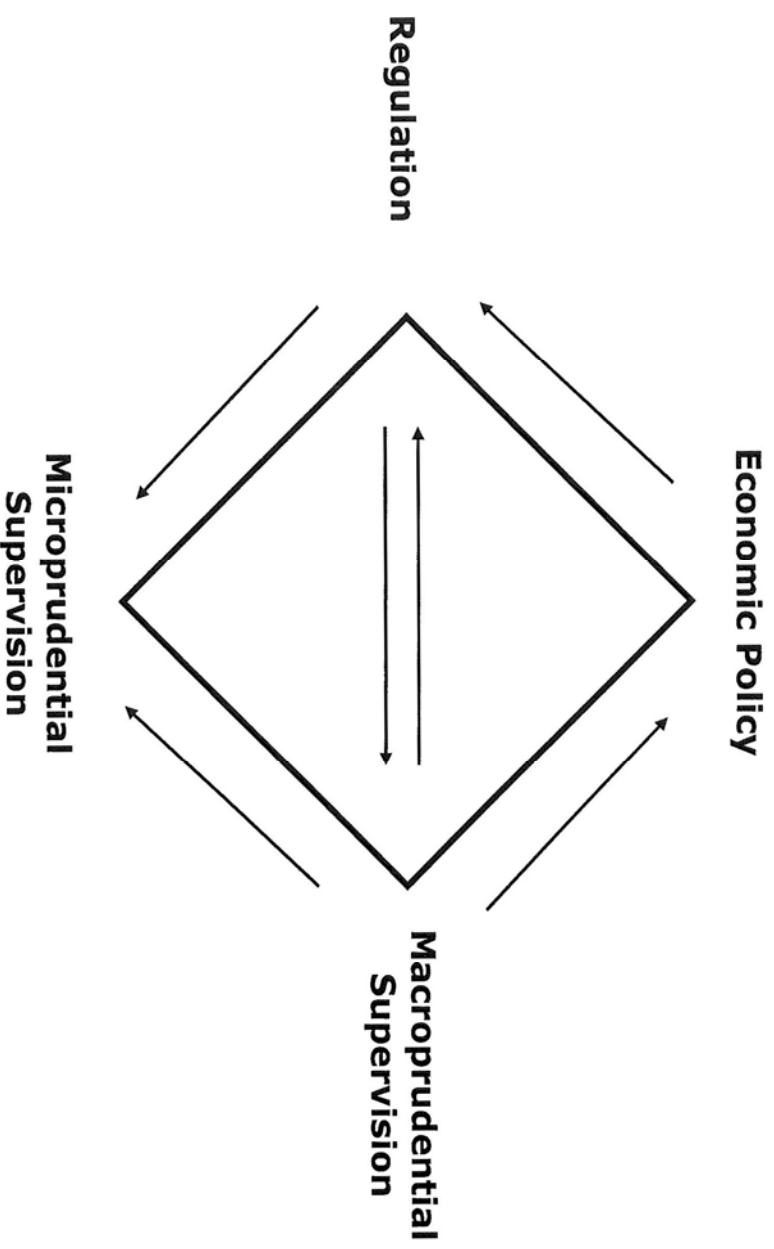
With specific reference to this last link, a clear lesson of the current crisis is that better regulation can only be achieved in terms of a two-way relationship with adequate supervisory arrangements.

In sum, the diamond approach is more complex, but more meaningful and powerful than the ladder scheme. The interdependence of the various facets is recognised and the central role of macroprudential oversight is highlighted.

The EU should therefore promote a clear focus on macro-prudential issues and processes. This is both because of the relevance of the function itself and as a result of the strong links between macroprudential assessment of risks and appropriate actions being undertaken, wherever necessary, in terms of (i) policies, (ii) regulations, (iii) microprudential measures.

The central role of this function is especially relevant in the more critical stages of the overall supervisory process: pre-crisis, to identify corrective and remedial actions, and crisis management and resolution, with the need for national governments involvement whenever tax-payers' money is at risk. This point and its implications are explored in the final paragraph.

New "Diamond" (de Larosière) Approach



3. Macro and Micro Prudential Supervision in Europe: the case for assigning Macrosupervision to the ECB/ESCB(ESRC).

The analytical thrust of the de Larosière Report leads to the need for Supervisory Repair in Europe. The core of the Report's proposals is indeed the establishment of two new institutions: the European Systemic Risk Council (ESRC), based on ECB/ESCB, to address macroprudential issues, and the European System of Financial Supervisors (ESFS) – an integrated network of European financial supervisors, based on enhanced L3 Committees (“Authorities”), to deal with microprudential tasks.

The goal of creating an effective European system of micro financial supervision is achieved, according to the Report, in terms of a process which might lead to, after a Review, no later than three years after its entry into force, inter alia to considering the case for wider micro supervisory duties at the EU level (this point will be developed in the concluding remarks).

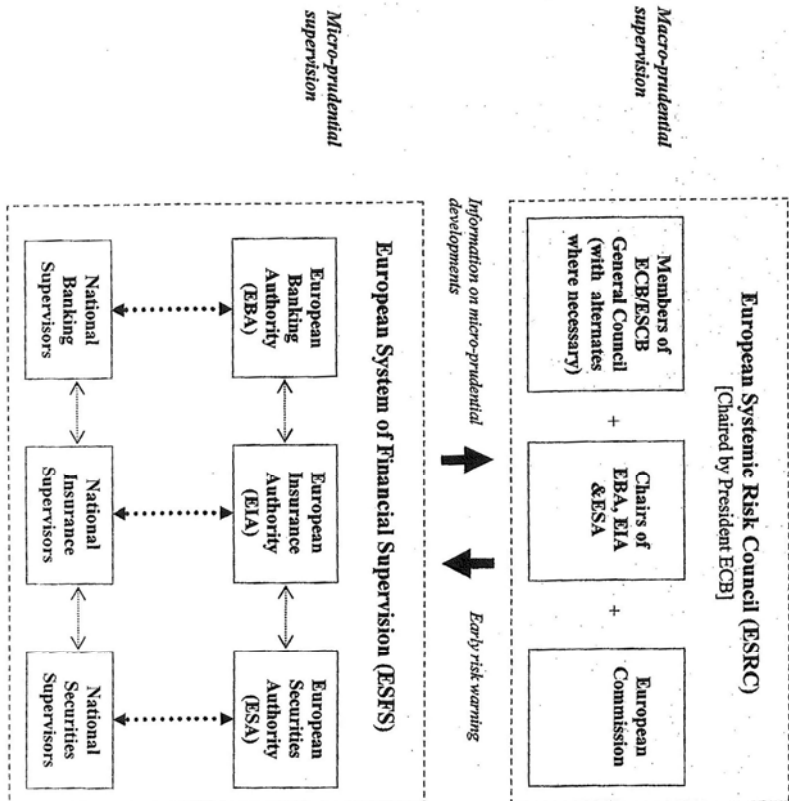
Slide 3 (taken from the Report) illustrates the two new bodies and their envisaged interactions.

The proposals made were clearly based on some key principles. I will enumerate those which are perhaps more relevant to assess the proposals made, that have been considered by some as overambitious, and by others insufficiently ambitious.

The first principle is that of avoiding discontinuities requiring either immediate Treaty changes, or an enhanced cooperation approach among a selected group of Member States.

While the current system is unsatisfactory and more responsibilities should be assigned to the EU level, institutional discontinuities would be extremely difficult to achieve in the short-run and unnecessary to act swiftly in order to build on existing structures and arrangements, with a view to achieving now a

Slide 3. A new European Framework for Safeguarding Financial Stability



Main tasks of the European Systemic Risk Council: decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues.

Main tasks of the Authorities: in addition to the competences of the existing level 3 committees, the Authorities would have the following key-competences: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) adoption of binding technical decisions applicable to individual institutions, (iv) oversight and coordination of colleges of supervisors, (v) licensing and supervision of specific EU-wide institutions (e.g., Credit Rating Agencies and post-trading infrastructures), (vi) binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and (vii) strong coordinating role in crisis situations.

Main tasks of national supervisors: continue to be fully responsible for day-to-day supervision of firms

substantive process within Treaty constraints and with the participation of all Member States..

A second guiding principle is subsidiarity: the burden of proof is to show that what is done at EU level implies higher efficacy and greater efficiency.

An example of the application of the two principles is represented by the issue of moving microprudential supervisory duties at the EU level. This has clear fiscal implications because of the need for national political and government involvement when taxpayers' money is at stake (there is an important difference in this respect with the US institutional arrangements). Any such move is therefore likely to imply institutional discontinuities. (I will return to this point later).

A third principle, which also has a time dimension, is that of neutrality with respect to existing national supervisory structures and systems.

A fourth principle refers to comprehensiveness: all aspects of supervision, all functions and forms of intermediation should be considered, also with a view to avoiding the re-emergence of parallel banking/financial systems.

A fifth principle refers to political and financial independence, and institutional accountability of the proposed supervisory institutions, to enhance their freedom of action and their legitimacy.

In the light of these principles, the pros and cons of the two principal options which are present in the current debate on supervisory reform in Europe can be estimated.

The first one refers to the improvement of convergence and cooperation among national supervisors through the enhancement of colleges of supervisors. This solution would leave almost unchanged the current system based on the principles of home and host controls and would require rules of coordination between the national authorities. These are necessary in view of the evident shortcomings which emerged during the crisis. The approach was in line with previous Ecofin roadmaps, which aimed at clarifying and increasing the role of

L3 Committees, without changing the non-binding character of their decisions and leaving them in an advisory role.

The second option refers to the enlargement of the ECB competencies and powers, and has been advanced by Baron Lamfalussy, President Trichet and other ECB members, and the de Larosière Group, with differing approaches.

Perhaps the most important difference lies precisely in the assignment to the ECB of (micro) supervisory tasks, in respect of large European cross-border banks. No clear operational definition of such banks has been put forward, but it is appropriate to recall that the 36 largest cross-border European banks (of which 22 are conglomerates) account approximately for some 70% of total European bank assets (deposits). The proposed assignment would thus imply a major change with respect to the current system.

The de Larosière Report does not support a role for the ECB in respect of micro-prudential supervision (par.171). Many reasons are given and are reported here:

- the ECB is primarily responsible for monetary stability. Adding micro-supervisory duties could impinge on its fundamental mandate; in case of a crisis, the supervisor would be heavily involved with the providers of financial support (typically Ministries of Finance) given the likelihood that tax payers money can be called upon. This could result in political pressure and interference, thereby jeopardising the ECB's independence;
- giving a micro-prudential role to the ECB would be extremely complex because in the case of a crisis the ECB would have to deal with a multiplicity of Member States Treasuries and supervisors;
- conferring micro-prudential duties to the ECB would be particularly difficult given the fact that a number of ECB/ESCB members have no competence in terms of supervision;
- conferring responsibilities to the ECB/Eurosystem which is not responsible for the monetary policy of a number of European countries,

would not resolve the issue of the need for a comprehensive, integrated system of supervision;

- finally, the ECB is not entitled by the Treaty to deal with insurance companies. In a financial sector where transactions in banking and insurance activities can have very comparable economic effects, a system of microprudential supervision which was not allowed to consider insurance activities would run severe risks of fragmented supervision.

To the above arguments I would add three additional considerations.

The first refers to the cumulation of responsibilities of micro and macro prudential functions, if the case for macroprudential responsibility is accepted.

The second regards the legal procedure necessary to achieve the proposed assignment of microprudential tasks. Art. 106 (5) of the Treaty is indicated as a legal means that would allow to change the European supervisory architecture without having to go through the very difficult negotiating process required by a modification of the Treaty.

But Art. 106 (5) requires unanimity within the Ecofin Council. Implementing this proposal requires therefore unanimous consent of Member States on the need for a European central system of supervision. Of equal importance – and difficulty – is the need for unanimity of central bank governors on the proposed change, which cannot be forced upon the ECB/ESCB.

In sum, important reasons militate against the option of a rapid move towards making the ECB as both the macroprudential institution in Europe and the single European supervisor for large banking groups.

The third is that microsupervision, in respect of crisis management and resolution has a necessary fiscal underpinning; the ECB has no European “sovereign” balance sheet behind its action (contrary to the FED in the United

States); and no country appears keen to move towards fiscal centralization in Europe.

4. Concluding remarks

If the view of the de Larosière Report is accepted that the ECB is ideally fit to play now an extended role in macroprudential oversight, the microprudential role becomes problematic.

Instead, there is, in my view, no compelling evidence that the conferring of the task of macrosupervision to the ECB should pass through Articles of the Treaty. In this respect, a broader issue is whether the ECB should over time, explicitly recognise that, beyond monetary stability, also broader financial stability is an objective of its policy conduct.

Monetary policy cannot be directed to prick financial bubbles. But central banks should assess and take into account asset price developments, and avoid the spreading of the belief of “Greenspan puts”.

Actions undertaken during the current crisis by the ECB are not inconsistent with this interpretation/extension. The partial overlap of monetary policy and macrosupervision is thus not without consequence (an augmented Taylor-Blanchard rule?),² but does not pose an immediate institutional problem.

Conferring the power of macrosupervision to the ECB (ESRC) is only one side of the solution. The ECB, acting as the macroprudential entity, would be able to identify the risks affecting the stability of the system as a whole, and to recommend the actions to be taken by national policy makers, by national supervisors and by the EU. The ESRC could count on intimate knowledge of and proximity to institutions, markets, products.

² Leaning against the wind of asset prices could be based on a different approach. Housing prices could be inserted directly in an extended price index, while equity price developments would be assessed in a subjective way.

As indicated in the Report, a risk warning framework must be identified with a view to ensuring that the identification of risks translates into appropriate action.

Beyond monetary policy, the ECB must coordinate its action with the EFC, the EC and the Ecofin Council. They should adopt – with the agreement of the European Parliament – common lines of intervention.

The power and the responsibility of taking any measures would still pertain fundamentally to the national level. Therefore, the conferring of the power of macro supervision to the ECB (ESRC) must, in any event, be coupled with the creation of a European system of microprudential supervision, as envisaged in the dynamic process outlined in the de Larosière Report.

As indicated in Slide 3, national supervisors would continue to be responsible for supervision of firms and markets, but the three Authorities would have the competence and responsibility of: (i) ensuring the composition of conflicts between supervisors (which is a necessary condition for the functioning, especially under stress, of the home/host system and of colleges of supervisors; (ii) adopting binding standards, to overcome the evident mismatch in Europe between integrated markets and fragmented regulation and supervision, (iii) cooperating and interfacing with the ESRC to build the necessary interaction between micro and macro prudential functions, and (iv) cooperating with national governments to ensure consistency, and consistent application, of deposit guarantee arrangements at European level.

I conclude by expressing some personal views on the possible evolution of the system. In the Report it is indicated that the functioning of the ESFS should be reviewed no later than three years after its entry into force. In this comprehensive review specific attention should be devoted to the issues of crisis prevention, management and, above all, resolution in respect of

systemically relevant cross-border banks/financial institutions. As we have learned, these intermediaries are pan-European (global) in life, but national in death; hence the national fiscal underpinning of crisis resolution.

In the light of the review, it may well be that the need will emerge that wider supervisory duties should be moved to the EU level, to deal with crisis management in respect of pan-European institutions: this would require bringing together in an appropriate way European microprudential responsibilities and national public finances. The French Commission Bancaire (COB) model has to my eyes an evident appeal, and could be transposed at European level, even without creating a European public finance balance sheet. In any event, the system should be designed to avoid distortions in competitions between large cross border complex financial institutions and smaller domestic banks.

If this line of reasoning is accepted, the competent European Institutions should address the issue, with a view to devising a satisfactory solution, which I believe may require Treaty changes. This ambitious plan can be put on a realistic footing only if the Ecofin - and hence the national governments - recognise the relevance of the problem and take promptly the initiative of putting the question on the table.