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# WORKING DOCUMENT

on Lamfalussy follow-up: future structure of supervision

Committee on Economic and Monetary Affairs

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## Introduction

This working document is intended to guide the first discussions in ECON on the initiative report on the "Lamfalussy follow-up: future structure of supervision", and to place the subject in the context of the present developments in the financial markets and in supervision and regulation.

This working document will first provide a short historical overview, then highlight relevant elements/causes of the on-going financial crisis, outline some policy implications, and finally raise some questions regarding policy implications in relation to the structure of supervision in the EU.

## 1. Historical background

Over the past couple of decades we have witnessed a rapid expansion and integration of financial markets - both in the EU and globally. The factors stimulating the growth of financial markets are several. They include advancements in technology, increasing wealth and demographic changes that have boosted the demand for financial services and capital funded pension savings. The euro has bolstered capital market growth in the euro area, mainly through substantially improved market liquidity. Technological and regulatory changes have helped to remove barriers to the cross-border provision of services and created conditions for consolidation. Not least, the rapid innovation of financial products played an essential role in boosting liquidity in the capital markets, but products such as derivatives also played a negative role in the current turmoil.

In parallel there have been developments in the regulation and supervision of financial institutions in the EU. Home country supervision was strengthened with the 2nd banking directive. Through a number of subsequent directives the Commission refined this system. The latest attempts are its proposals on Solvency II and its consultation on the Capital Requirements Directives (CRD).[1]

The institutional landscape changed as well. In 2001 it was decided to set up the so-called Lamfalussy structure, including the establishment of the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). Subsequently EBC[2], CEBS[3], EIOPC[4] and CEIOPS[5] were added.

Through the so called Level 3 committees (CESR, CEBS and CEIOPS) more than 80 national supervisors in the EU have been brought together. However, it is clear that this does not match the integration of the wholesale financial markets, where some 40 large cross border groups conduct the bulk of transactions.

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[1] Directives 2006/48/EC and 2006/49/EC
[2] European Banking Committee
[3] Committee of European Banking Supervisors
[4] European Insurance and Occupational Pensions Committee
[5] Committee of European Insurance and Occupational Pensions Supervisors

The European Parliament has voiced its concerns in a number of reports and debates[1] about the widening gap between the reality of this integrated financial market and the fragmented supervisory architecture and pointed out that neither the powers, nor the responsibilities of EU supervisors, nor crisis management arrangements, are sufficient to cope with cross-border stress situations.

## 2. The current crisis

The crisis has been triggered in the US, while its roots have both a cyclical and structural nature. Through mortgage brokers mortgages were provided to people who were not able to put any down-payment and to afford the monthly payments. Moreover, since it was assumed that house prices would always go up the home-owner could later re-mortgage. It must be recalled that some of these products were also available in the EU.

The banks providing such mortgages would pack these and other high risk loans into securities - such as Collateralized-Debt-Obligations (CDOs) or other complex financial products - in order to externalise their risks. These complex financial products have been structured with the aid of lawyers, accountants and credit rating agencies. The same Credit Rating Agencies provided the complex financial products with high ratings.

The complex financial products the bank could or would not sell could be either kept on the books at "fair-value" or a value determined through modelling, or sold on to special purpose vehicles located off-shore. The buyers of these high risk securities were other banks, pension funds, insurance companies or investors with an appetite for risk and high reward. Many of the buyers may even have re-engineered these securities into more complex financial products with a view to selling them on.

This financial product engineering was accompanied by a dramatic increase in the volume of financial intermediation outside the core banking system –in the so called shadow banking sector. There were no appropriate regulatory and supervisory adjustments made in order to cope with the systemic risk stemming from the impressive increase of capital market intermediation, the rising importance and market share of these new products and vehicles and the increased activity of broker dealers, hedge funds, mutual funds and pension funds.

Because of abundant and cheap liquidity and ignoring the lessons of previous episodes of crisis supervisors and regulators have underestimated/overlooked the important financial stability implications, which adverse market conditions (i.e. liquidity disruption/squeeze) could trigger. They have also poorly understood the flaws and implications of the “originate and distribute model” of securities, which was practiced by major banks. This model was carried on because those selling and buying highly innovative financial products would be rewarded for doing so. Their rewards were and are largely based on short term gain rather than sustainable long term growth.

[1] EP resolution of 11 July 2007 on Financial services policy (2005-2010)- White Paper
EP resolution of 4 July 2006 on consolidation of financial services industry
EP resolution of 28 April 2005 on the current state of integration of EU financial markets
EP Resolution of 21 November 2002 on Prudential supervision rules in the European Union

For a long time only a small part of the financial industry paid attention to the risk which complex financial products carried. This was partly because they were rewarded handsomely for not paying attention, and partly because the financial products had become so complex and opaque that it was not possible to understand the risk they carried.
Alexander Lamfalussy and the *Committee of Wise Men*, in their 2001 report on European securities markets already underlined that there is an important trade-off between apparent higher efficiency and financial stability.

Furthermore, the crisis was compounded by non regulated and unsupervised markets as well as off-balance sheet arrangements, special purpose vehicles and opaque and non- transparent OTC derivatives markets. These did not mitigate the risk but, in stress conditions, turned into major hubs where counterparty risk concentrated. Because of the peculiar features of such innovative products and OTC markets, the counterparty risk was more than difficult to detect/follow.

Ironically, financial innovation that was designed, purportedly, to diminish risk at the individual/micro level ended up in exacerbating it at the macro level, thus enhancing systemic risk. In hindsight, episodes such as LTCM, Enron, Dotcom, can be seen as stress tests for the financial system. Although those crises were quite severe, their global effects were contained in the end because, at those periods of time, the financial markets' degree of sophistication did not, arguably, reach the level and depth as seen nowadays.

The recent events have highlighted a number of issues. There are new sources of systemic risk, which are either not, or only very lightly, regulated and supervised. There is a serious lack of transparency and trust in the market. The pace and speed of contagion seem to have taken market participants and supervisors by surprise. To many it was a surprise that the crisis started in the regulated financial sector and spread out so fast to other sectors.

## 3. Policy Implications

It is evident that we are not only witnessing a massive market failure, but also a severe regulatory and supervisory failure. Both call for strong responses from policy makers and regulators.

There is evidently a lack of comprehensive analysis of the adequacy of internal risk management practices, valuation practices, incentive schemes, accounting rules, and the adequacy of capital buffers/requirements, which might highlight where it would be necessary to improve the existing EU regulatory framework and supervisory architecture. The Commission should screen the existing regulatory, supervisory and crisis management framework in the light of the identified failures. The Commission's tampering with long overdue elements of the Capital Requirements Directive (which is dealing with a legacy from the past) and a vague promise to regulate Credit Rating Agencies are all but an appropriate policy response to the current crisis.

Integration, globalization, open financial markets and the challenges that come along with them, will remain a reality. The regulatory and supervisory world must learn how to cope;

they need comprehensive reform. In this respect, the financial crisis underlines more than ever how desperately major change of the existing EU supervisory set up is needed.

Through many hearings, discussions, reports and resolutions the European Parliament has analysed many aspects of the current crisis. The co-rapporteurs believe that adequate policy responses to the below highlighted issues/failures are necessary:

- The new sources of systemic risk, which are not properly addressed by existing regulatory frameworks and self-regulation, or neglected by supervisors and other oversight financial bodies. The main features of the regulatory and supervisory frameworks and tools for preventing and managing financial crises have hardly changed since the bank - dominated era.
- The link between regulation and supervision, taking into account that failure or weakness in either of them generates massive negative externalities for the entire financial system and poses a serious threat to the real economy.
- The fact that the crisis started in regulated markets, suggesting that the existing financial market regulation could not cope with it and significant revision and changes may be needed.
- The failure of banks to properly assess and manage their risks. Internal risk management practices and stress testing were either poor or missing.
- The fact that banks relied excessively on models which failed when exceptional events occurred. Valuation standards were weak and often differed from bank to bank. Accounting rules applied to complex financial products, in stress situation turned out to be completely misleading and triggered a vicious circle of sharp price falls.
- Banks' compensation schemes rewarded excessive risk taking instead of providing incentives for proper management and medium to long term sustainability.
- The lack of transparency on the OTC derivatives markets, where counterparty risk and legal certainty issues need to be addressed,
- The securitization (originate-and-distribute, OAD) model that almost decoupled the link between debtor and creditor. There was hardly any incentive to oblige the various stakeholders involved in the OAD process (from brokers, mortgage banks, investment banks, rating agencies) to properly evaluate and monitor the debtor's financial situation. Perverse rewarding incentives only exacerbated the situation.
- The fact that rating agencies perform a "public utility" role. This role which has been further strengthened by the Basel II framework requires solid, transparent and credible ratings, adequate rating methodologies, internal processes and safeguards against conflicts of interest. The failures of rating agencies generated substantial negative externalities and additional market uncertainties and substantial spill-over effects. Rating agencies have offered unsatisfactory solutions from a point of view of a comprehensive risk assessment.
- Serious doubts about the efficiency and appropriateness of the existing EU crisis prevention and management arrangements have long been voiced. The core elements of crisis management policy in the EU, such as information exchange and cooperation, rely on Memorandums of Understanding that are not legally binding, i.e. on voluntary cooperation. Fortunately, Europe was, until now, spared the failure of a major cross-border bank. A comprehensive reform of the core elements of the crisis management framework should be considered in order to make it clear, legally binding, responsive

and effective at the European level. Deposits in Europe must be properly protected and a solid solution to burden sharing must be found.

- The link between macro prudential oversight (macroeconomic stability analysis) and micro prudential oversight (the actual supervision of financial institutions) has been neglected in both national and European supervisory architecture. Information inadequately collected and analysed by Central Banks and by prudential supervisors is badly combined.
- The effectiveness of existing monetary policy tools in stress situations is weakened given the important shift towards capital market intermediation.
- The low capacity of existing international institutional arrangements to deal with markets under stress conditions, and ultimately, the lack of proper global governance; in this respect, the institutional set up at global level and the possible role of the International Monetary Fund should be looked at.

The co-rapporteurs would welcome reactions to the above issues. Do members share the analysis? And what are the lessons to be learned for the supervisory framework?

**4. Reforming the EU supervisory framework**

Five years ago, the nationally and sectorally based supervisory set up in the European Union was complemented by establishing three European sectoral committees of supervisors - the so-called Level3 Committees (3L3)[1]. Their role and status within the supervisory framework at the EU level is formally only an advisory one but it has developed in practice into much more. They play a major role in convergence and coordination of implementation and enforcement of EU regulation. The shortcomings of their competences and tools were signalled in several reports[2].

Recently also colleges of supervisors have been established for cross border financial groups. They have made arrangements in MoUs. A common feature of the first colleges (e.g. Euronext, Nordea, Fortis and ING) was that leading roles were distributed over the different national supervisors involved in a rather balanced way. In case of the colleges currently being discussed in relation to Solvency II, the host supervisors have to rely heavily on the information and know-how of the home supervisor - consolidating supervisor (supervisor in the country where the headquarters of the group are established), although for their country the activities of the foreign based financial group may be of systemic importance.

On top of the complexities of burden sharing, transfer of capital and deposit guarantee provisions, the present situation may also lead to regulatory competition: Member States trying to attract the head quarters of financial institutions not only with fiscal incentives but also with light regulatory regimes.

These and other problems have been discussed in several recent reports[3]. The European

[1] CEBS, CEIOPS and CESR

[2] Final Report of the Inter- Institutional Monitoring Group (15/10/2007); "Himalaya" report on Supervisory convergence of the CESR (25/10/2004); FSC Report on financial supervision of February 2006 (Francq Report)

[3] See footnote n.6

Parliament proposed to set up a new Group of Wise Persons[1]. The European Commission and the ECOFIN Council have set up Roadmaps[2]. Currently, only two legislative proposals rearranging elements of the supervisory framework in the EU insurance sector and in the EU banking sector are on the table. Furthermore, smaller step changes regarding the 3L3 Committees status, role and financing are under way.

Several options for reforming the EU supervisory framework have crystallized over the past many years of discussion. For the purpose of starting a debate about the architecture of supervision, but without making choices or promoting one or the other option, they can be outlined as follows:

**Option 1: Improvements within the present fragmented structure**
This option leaves the 3L3 committees' advisory status, competences, instruments and working methods untouched or only slightly modified. The question is whether they have the necessary powers to meet the high expectations regarding securing supervisory convergence and cooperation, and building a common EU supervisory culture, and beyond that to prevent and properly intervene in critical situations? Would measures of a voluntary legally non-binding character create the necessary pressure to exchange information and cooperate in times of market stress and most importantly in times of a real cross-border crisis? Is it possible to commit only nationally mandated regulators to accept decisions made by qualified majority? Would colleges of supervisors with a leading role assigned to group supervisors create the necessary trust among supervisors? Isn't there a risk that setting up various colleges of supervisors for cross-border financial groups of various compositions will end up by fragmenting the EU supervisory framework even more? Would the EU supervisors speak with one voice when dealing with third country supervisors? Would the voluntary EU Memoranda of Understanding on cross-border crisis management sufficiently commit the authorities to cooperate and have the broader European risks and interests in mind?

**Option 2: Transforming the L3Committees into European regulatory agencies**
The second option raises practical questions such as how such a reform could be institutionalised. Certainly, some inspiration could be drawn from the existing EU framework of agencies. And in this case too, the question must be asked of how effective can the agencies be in securing a true supervisory cooperation and convergence? How could confidence among the supervisors be built? Would they operate in the European interest? Could their decisions be binding? Would the agencies be capable of addressing substantially various sources of systemic risk and enhance financial stability? Would such agencies be able to represent the EU vis-à-vis the outside world, would they be the partners for dialogue and negotiation on supervisory matters? How would their role relate to that of the European Commission and to other European and international institutions?

**Option 3: A European System of supervisors with a two-tier supervisory system**
The third option is to create a pan-European structure for prudential supervision of the major cross-border financial groups, on top of but closely linked to the existing system of

[1] EP resolution of 4 July 2006 on consolidation of financial services industry ( P6_TA(2006)0294 )
[2] ECOFIN Council Conclusions on Financial Stability Arrangements (9 October 2007) and ECOFIN Council Conclusions on Review of the Lamfalussy process ( 4 December 2007 )

cooperating national supervisors. The main argument for the transfer of the prudential supervision of these groups to the European level is the systemic risk that such financial groups pose to the entire EU financial system. This second tier would coexist under the same rules with the existing system of national supervisors for all other financial players that still form the major numbers of actors in the financial sector. Here the main concern is the level playing field between institutions supervised at the European level and those supervised at national level. Another issue is the relationship with the European System of Central Banks.

**Option 4: Single European Supervisor**
Further reaching than option 3 would be a Single European Supervisor that would be covering all financial services sectors: capital markets, securities, insurance and banking sectors and all aspects of supervision. This model would fit a situation where also a fully integrated retail finance market exists. It poses a number of questions, such as: Would such a single European entity be orchestrated for each of the financial sectors or would it be based on an integrated model? In case of sectoral single supervisors, how would cross-sectoral consistency and cooperation be achieved?

**Option 5: An EU Financial Oversight Authority:**
In the USA there is a discussion now about creating an overarching Supervisory Oversight Body. For the EU this could also be considered. The main focus of this Oversight Authority, that could also involve representatives of the ECB, would be to assess systemic risks for the stability of the EU economy as a whole. This would require adequate cooperation of all supervisors involved. Could such a structure be established only at a voluntary basis, or would it require also binding EU legislation and a Treaty basis? The condition sine qua non for such an oversight to be effective is adequate and timely provision of data and confidential and (competition) sensitive information. Would national supervisors be ready and willing to provide this? What would be the role and influence of the European Commission? How could democratic accountability vis-à-vis the European Parliament and national Parliaments be ensured? How would the independence of such an Oversight Authority be guaranteed and how would this independence relate to that of the other authorities (e.g. the ECB) that would be covered? How finally could the creation of such an Oversight Authorities in different parts of the global financial marketplace (in US, EU, Japan, China etc) fit into the creation and reinforcement of a strong global structure for oversight of the global financial markets?

The above options are meant to stimulate discussion, but not yet proposals from the co-rapporteurs. The co-rapporteurs hope to get guidance from the reactions to the above options with a view to drafting more concrete suggestions in their draft report.