What role for the ECB on financial market supervision?

Briefing Paper for the Monetary Dialogue of March 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

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Executive Summary

The main recommendations made by the High-Level Working Group chaired by Jacques de Larosière are a political compromise between the EC, ECB, EU national central banks and supervisors and ministers of Finance and should be taken as the points of departure. A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logical support of the ECB. – The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as the European Commission. High-level alternates to the central bank Governors should take part in the discussions, in particular when insurance or securities markets issues are discussed. An effective risk warning system shall be put in place under the auspices of the ESRC and of the EFC. – The ESRC should issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU. In a first stage, national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU. The European Commission should carry out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This should lead to concrete recommendations, including on the funding of national authorities. In a second stage, the EU should establish an integrated European System of Financial Supervision (ESFS). The level 3 Committees should be transformed into three European Authorities: a *European Banking Authority*, a *European Insurance Authority* and a *European Securities Authority*. The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years. The Authorities are responsible for micro-prudential supervision, while the ECB takes care of macro-prudential supervision by participating in the ESRC as suggested by the High-Level Working Group. This should be realized under clear mandatory arrangements for information and knowledge exchange. The recommendations of the Working Group are not path breaking but a very modest, first step to European supervisory authorities.

1. Introduction[1]

The future architecture of supervision in Europe is indeed one of the main issues following the crisis. The *De Larosière group* has been set up to deal with this question, and has come out with a report on February 25th, 2009[2]. The President of the European Central Bank (ECB), Mr Jean-Claude Trichet, has been heard by this group. This topic will be discussed in the meeting of the *European Council* in March 2009 and during the informal meeting of the *Ecofin Council* (ministers of Economic Affairs and Finance) in April 2009. The ECB is in the process to finalize its official position on the question. During the last Monetary Dialogue in the European Parliament on January 21st, 2009, Mr Trichet concluded his introductory remarks by saying that "*as underlined in particular by a number of Members of Parliament, Article 105(6) of the Treaty explicitly mentions the possibility for the Member States to decide to confer upon the ECB specific tasks in the domain of financial supervision. Reflections have started on the specific role that could be played by the ECB and its Governing Council should this provision of the Treaty be activated. At this stage the Governing Council has not taken yet position on this topic. I will not miss to report to you the outcome of these reflections*". This Briefing Paper analyzes how to (re-)organize financial supervision on the European Union (EU) level. Section 2 of this Briefing Paper focuses first on the current system and its flaws. In Section 3 we will consider the possibilities to enhance EU-wide supervision. Section 4 discusses a European system of financial supervisors and the role of the ECB in the review process. In Section 5 we evaluate the pros and cons of the ECB model versus European Financial Services Authority (EFSA) model. Finally, in Section 6 we draw some conclusions.

2. What does the current system look like?

The current system of supervision is characterized by the concept of home country supervision, which is recognized by host country supervisors. The latter only has supervision over subsidiaries (separate legal entities) of financial institutions in their country. However, the effect of this on financial stability is limited in practice, as most important decisions are often taken by the parent company in the home country. Additionally, the financial health of the group as a whole greatly affects the well-being of the subsidiary[3]. The important question is whether this system is still sustainable in an integrating market, with large cross-border financial groups and the centralization of management functions at the company headquarters incorporating insurance and banking in the same entity. This system of supervision also has a financial stability component. This is organized at the EU level, as described in Table 1. The coordination of supervision exists of cooperation between national supervisors through the 3L3 committees from the *Lamfalussy framework*, to prevent financial crises. The ECB and the ESCB also play an important role here. Crisis management and crisis resolution is mainly

[1] The author gratefully acknowledges the excellent research assistance of Mr Rob Nijskens, MSc.

[2] De Larosière Group (2009), *Report by the High-Level group on financial supervision in the EU*, February 25th , 2009.

[3] Schoenmaker, Dirk and Sander Oosterloo (2008), 'Financial Supervision in Europe: A Proposal for a New Architecture', in: Lars Jonung, Christoph Walkner and Max Watson (Eds), *Building the Financial Foundations of the Euro - Experiences and Challenges*, Routledge, London, pp. 337-354.

coordinated through Memoranda of Understanding, to foster cooperation between the national supervisory authorities and the ministries of finance.

Table 1: The EU framework for safeguarding financial stability[4]

Functions	*Structures for cross-border cooperation between authorities*
Crisis Prevention	
Supervisory functions	Level 3 Committees for the convergence of supervisory practices Colleges of Supervisors
Financial stability monitoring by central banks	ESCB Committees
Crisis Management	
Supervisory measures	Colleges of Supervisors EU MoUs
Provision of liquidity by central banks	Eurosystem
Actions on payment systems	ESCB Committees EU MoUs
Crisis Resolution	
Private sector solutions	EU MoUs
Public sector measures by finance ministries	EU MoUs
Reorganization and winding-up of financial Institutions	Bilateral relationships between the competent authorities of Member States
Deposit guarantee schemes	Bilateral relationships between the competent authorities of Member States

The Lamfalussy system has recently been reviewed by the Ecofin Council. The results of this review should lead to a better coordination of European-wide financial supervision. The changes also facilitate the transition to a new system of EU-wide financial supervision, as the 3L3 committees get more responsibilities.

The first change to be made is strengthening the legal basis of the Level 3 committees, to clarify their role in promoting supervisory convergence and cooperation. Secondly, the accountability of the committees is to be enhanced by a specification of their objectives and a periodic reporting scheme to the European Commission, the Ecofin Council and the European Parliament. In the light of this second suggestion, it may also be wise to explicitly burden national supervisors with fostering EU-wide supervisory convergence. Thirdly, qualified majority voting can improve the decision-making process within and between the 3L3 committees.

[4] ECB (2008), 'Developments in the EU arrangements for financial stability', *Monthly Bulletin*, April, pp. 75-87.

However, the recent turmoil has revealed increasingly more weaknesses in the EU supervisory system, which has been assessed by the High-Level Working Group led by Jacques de Larosière. Below, we will address the main problems with the current system.
To start with, having many different systems of supervision in each country creates duplicated rules and information inefficiencies that bring extra unnecessary regulatory costs for internationally oriented financial institutions. Furthermore, the legal structure in supervision is no longer in line with the organizational structure of financial institutions, due to cross-border activities. In other words: the regulators have not adapted the supervisory structure to market developments, and this has led to the above-mentioned inefficiencies. The High-Level Working Group has identified loose monetary policy as one of the main causes of the financial crisis. Admittedly, this has been the case mostly in the US but also in the EU the current system may allow for conflicts of interest. The current system also allows for moral hazard on the side of financial institutions, as the supervisor is also the one that has to finance a bailout. Furthermore, there is has been insufficient attention for systemic stability and the examination of macro-prudential risk at the EU and global level. This has occurred under a lack of coordination between supervisors EU-wide and globally; a problem that a new system for financial supervision will have to solve. In the next section we will explain what aspects are needed for a more coordinated EU-wide system of supervision.

3. A new approach to EU-wide financial supervision

The question of restructuring the European supervisory system pertains mainly to financial and systemic stability, and thus we are not as such concerned about coordination of conduct of business supervision. We will focus attention on prudential supervision in the text below. As we have seen in the previous section, there are important reasons why the European Union needs a new system of financial supervision. Besides the obvious failures during the financial crisis, there are several other reasons to form a system of integrated financial supervision[5].
First, it is already mentioned above that financial institutions have increasingly expanded internationally. Supervision should follow this trend, to prevent inconsistencies or gaps in oversight. Second, there is the need (especially in the EU) to create a level playing field in regulation. This will eliminate regulatory arbitrage and regulatory advantages for financial institutions in one country over those in another. Finally, efficiency has to be improved, by reducing duplication of supervisory effort and thus lowering the overall costs of supervision. But how should we realize this coordination of supervision at the European Union level? Different suggestions have been made for coordinating EU-wide supervision[6]. A first one is strengthening cooperation between home and host countries. This has been arranged in the EU via the Lamfalussy framework, such that home and host supervisors can effectively communicate about regulating cross-border financial groups. However, this system has proven to be insufficient during the crisis. Furthermore, it is questionable whether this improvement of cooperation will reduce duplication and

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[5] Herring, Richard J. and Carmassi, Jacopo (2008), 'The Structure of Cross-Sector Financial Supervision'. *Journal of Financial Markets, Institutions & Instruments*, 17 (1), pp. 51-76.

[6] Schoenmaker, Dirk and Sander Oosterloo (2008), 'Financial Supervision in Europe: A Proposal for a New Architecture', in: Lars Jonung, Christoph Walkner and Max Watson (Eds), *Building the Financial Foundations of the Euro - Experiences and Challenges*, Routledge, London, pp. 337-354.

overlap of supervision. As mentioned before, this leads to a high regulatory burden and hampers competition and expansion within and outside of the EU. An additional problem with this framework is that it is unclear where responsibilities for crisis management and bailouts lie.

A second suggestion, also made by the *European Financial Services Round Table* (EFR), is the definition of a lead supervisor for prudential supervision of cross-border financial institutions. This supervisor would be the contact point for all issues related to prudential supervision. Next to this supervisor, colleges of supervisors for each specific cross-border financial group should be set up to advise the lead supervisor. This has also been suggested by the High-Level Working Group. Although this solution takes care of coordination and inefficiencies, it does not solve the lack of attention paid to cross-border externalities and systemic stability. The third suggestion, recently made by both the EFR and the High-level Working Group, is a *European System of Financial Supervision* (ESFS). This can level the playing field, and foster an efficient exchange of information between supervisors, especially on large cross-border institutions. It consists of a central body, coordinating supervision and information exchange, and the 27 national supervisors that will conduct day-to-day supervision. Since this solution has the possibility to solve all the problems mentioned above, we will examine the option further in the next section.

4. A European System of Financial Supervision

The proposed system of financial supervision at the EU level should satisfy certain requirements. To begin with, the system and its central agency should be independent; they should be free of political influences, but accountable to a democratic institution such as the European Commission, the Ecofin Council and the European Parliament. Second, the day-to-day (micro-prudential) supervision should take place close to financial institutions. This can be done by the national supervisors, since they usually already have a good relationship with their home financial institutions. Thirdly, decision-making should be based on unanimity or qualified majority voting, except in times of crisis; there should be some discretion in this. Furthermore, there should be made clear arrangements for burden sharing in crisis management[7]. Finally, a mandatory exchange of information is desirable. This can be arranged in EU legislation, to level the playing field and take care of cross-border financial groups. The High-Level Working Group has suggested a system to be implemented in the medium term. It consists of two blocks: a *European Systemic Risk Council* (ESRC) and a *European System of Financial Supervision* (ESFS). The first body will pay attention to macro-prudential risks and systemic stability, and it will closely work together with the ECB. It can also issue risk warnings with mandatory follow-up by national supervisors. The second body will cover micro-prudential supervision, and consists of the transformation of the 3L3 committees into 3 new European authorities, that will take care of common supervisory standards and coordination of supervision and will closely cooperate with the ESRC to bring in line macro- and micro-prudential supervision.

The High-Level Working Group has suggested to implement this framework in two stages: a preparation phase (2009-2010) and the establishment of the ESFS legal system

[7] Goodhart, Charles and Dirk Schoenmaker (2006) "Burden Sharing in a Banking Crisis in Europe", Economic Review, No. 2.

(2011-2012). Furthermore, a periodic review should be undertaken to determine whether further development may be necessary. What should the ESFS look like? We suggest the creation of a *European Financial Services Authority* (ESFA) to serve as the central authority in this system. This EFSA will be responsible for the direct supervision of internationally active financial institutions and national financial institutions that can affect financial stability internationally. National supervisors will be responsible for smaller institutions, although they will be accountable to the EFSA. They can also help the EFSA in gathering information, so the EFSA will be the umbrella organization for national supervisors. The system also entails uniform supervisory rules for national supervisors, to create a level playing field and to prevent regulatory competition within the EU. Furthermore, this leads to lower information costs and prevents regulatory arbitrage by large financial institutions. The structure of the ESFS and EFSA can be designed by using the ESCB and the ECB as a blueprint: key supervisory decisions and the design of policy can be made at the centre. This should be done by a Governing Council consisting of the Executive Board of the EFSA and the Chairmen of the 27 national supervisors. It should be clear, however, that the EFSA is a federal institution operating independently from the ECB or any other institution. This does not mean that they do not cooperate: it is crucial that there is a legally binding information exchange between the EFSA and the ECB or the ESRC, when using the suggestion by the High-Level Working group. Finally, this EFSA will be only responsible for supervision and not for bailouts in times of crisis. It will not get any funds to save financial institutions; instead, the costs of these actions will have to be shared by the involved Member States. To prevent moral hazard clear arrangements for burden sharing have to be made, as mentioned in the beginning of this section. The implementation of this new system of EU financial supervision can be done according to the recommendations made by the High-Level Working Group. This means that during 2009 and 2010, national supervisory authorities should be strengthened with the aim to upgrade the quality of supervision in the EU. This can for instance be achieved by examining the degree of independence and by working towards a strong European supervisory culture. Furthermore, EU should develop a set of harmonized rules on financial regulation and supervision.

The second stage, in 2011 and 2012, could see the establishment of an integrated European System of Financial Supervision (ESFS) in the shape of a European Financial Services Authority (EFSA) having political independence. This should be underpinned by legally binding mediation between national supervisors, supervisory standards, technical decisions and mandatory cooperation with the ESRC to take care of systemic stability. In this system, national supervisory authorities remain responsible for the day-to-day supervision of smaller financial firms, while the EFSA supervises large cross-border financial groups.

The most important part of these suggestions at this moment is that their implementation should start immediately, since it has become clear that coordination and cooperation at a higher level has become indispensable. Additionally, it may be wise to intensify cooperation at the global level, i.e. in the *Financial Stability Forum*. However, EU supervision should be strengthened first in order to have a stronger bargaining position at the global regulatory playing field.

5. The ECB model versus the EFSA model

It has also been suggested to direct the task for EU-wide supervision to the ECB. However, the High-Level Working Group mentions several reasons not to do this. The most important one is that loose monetary policy has been a problem and thus conflicts of interest are an important issue.

This can be mitigated by not giving the ECB responsibility for financial supervision, but instead separating the tasks of macro- and micro-prudential regulation. Furthermore, centralized supervision should cover the whole European Union, not only EMU, to prevent the perverse effects that have lead to opaqueness and the recent systemic failures. Also, financial institutions are not confined to the borders of EMU. An additional advantage of focusing on the EU, instead of only on EMU, is that financial supervision will not be easily related to monetary policy.

Below, in Table 2, we delineate the pros and cons of both the ECB model and the EFSA model. As we can see, advantages of the ECB model are its emphasis on system-wide stability, the information synergies and expertise and the possibility of firm action in case of crisis. However, the disadvantages, mainly concerning micro-prudential supervision, are considerable. To start with, the arrangement may lead to a concentration of power in the ECB. The responsibilities for financial supervision and monetary policy in one body decrease transparency, and may lead to situations of moral hazard. Finally, adverse developments in the financial stability domain may lead to reputational damage for monetary policy. The EFSA model can easily create a level playing field for the whole EU, lower the information costs, reduce problems of moral hazard caused by bailout possibilities, reduce the probability of mistakes when more institutions look at a case during crisis management and, most importantly, eliminate possible conflicts of interest and reputation effects as it separates monetary policy and financial supervision. Although a large disadvantage is that this model pays little attention to systemic stability, this can be solved by introducing mandatory information exchange between the EFSA and the ECB or ESRC.

Table 2 The ECB model vs. the EFSA model

	Pro	*Con*
ECB model	+ Attention for systemic stability + Information synergies, knowledge and expertise + Independence + Higher transparency due to absorbing 3L3 committees + Effective crisis management	- Possible conflict of interest - Reputational concerns for monetary policy - Moral hazard problems - Less transparency due to mix financial and monetary stability - Concentration of power - No EU legal basis for insurance supervision.
EFSA model	+ Level playing field for the whole EU, not only EMU + No conflict of interest + No concentration of power + More transparency: only one task + Less moral hazard concerns + No reputational effects for monetary policy + Crises are assessed by different authorities: fewer mistakes.	- Not much attention for systemic stability - ECB has the knowledge and expertise already; information exchange mandatory - Less decision/acting power in crises: more institutions involved - Needs a EU constitutional change

6. Conclusions

The main recommendations made by the High-Level Working Group chaired by Jacques de Larosière are a political compromise between the EC, ECB, EU national central banks and supervisors and ministers of Finance and should be taken as the points of departure.
A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logical support of the ECB. - The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as the European Commission. High-level alternates to the central bank Governors should take part in the discussions, in particular when insurance or securities markets issues are discussed.
An effective risk warning system shall be put in place under the auspices of the ESRC and of the EFC. - The ESRC should issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU.
In a first stage, national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU. The European Commission should carry-out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This should lead to concrete recommendations, including on the funding of national authorities.

In a second stage, the EU should establish an integrated European System of Financial Supervision (ESFS). The level 3 Committees should be transformed into three European Authorities: a *European Banking Authority*, a *European Insurance Authority* and a *European Securities Authority*. The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years.
The Authorities are responsible for micro-prudential supervision, while the ECB takes care of macro-prudential supervision by participating in the ESRC as suggested by the High-Level Working Group. This should be realized under clear mandatory arrangements for information and knowledge exchange. The recommendations of the Working Group are not path breaking but a very modest, first step to European supervisory authorities.

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