EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

A New Life for European Financial Supervision

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Trilemma of Financial Integration, Financial Stability and National Supervision

On December 2nd the ECOFIN Council will review, and possibly adopt, proposals advanced by the European Commission on September 23, 2009 to set up an advisory European Systemic Risk Board (ESRB) and to upgrade the EU bodies of national supervisors that monitor individual banks and insurance companies as well as securities markets into a European System of Financial Supervisors (ESFS).

We see these complex, and in some respects bold and controversial, proposals as constructive efforts to lessen the risk of a repeat of the traumatic experience of financial turbulence over the past couple of years. But they fall short of achieving the objective of reconciling stability with deep financial integration of European financial markets, rightly seen as an important contribution to an efficient and growing economy. To do that, policymakers would have had to confront more directly the "trilemma" – a situation in which it is only possible to achieve two out of three desirable features, in this case financial integration, financial stability and national supervision. Opinions on where priority should lie in resolving this trilemma are not unanimous, and the required broad-based political debate has so far not even started. ***With the new emphasis on strengthening financial stability following the recent crisis there is a danger that financial integration could be jeopardized due to the fact that supervision is exercised by national supervisors and not by a European supervisor.***

There is an analogy to the process of creating the euro. In Maastricht, nearly two decades ago, EU member governments also faced a trilemma: could they combine freedom of capital movements and exchange rate stability, while retaining national monetary policies? Most of them decided they could not, and the Treaty was changed to provide a framework in which a joint monetary policy replaced national policies. Today governments can not, in the foreseeable future, envisage a Treaty change, even if they might agree on what it would take to make it possible to assign responsibility for financial supervision to the EU level. They have to "muddle through" by improving coordination of their respective abilities to identify systemic risks as well as those facing individual financial institutions. While making the best of this task, ***the European Shadow Financial Regulatory Committee (ESFRC) strongly encourages the relevant political authorities to pay particular attention to the implications of cross-border activities of the large banks and to urgently consider the creation of a European supervisor for these large, pan-European banks in the future.***

European Systemic Risk Board

The EU regulatory and supervisory framework of home country control based on mutual recognition and minimum standards has accomplished a great deal in promoting the objectives of the European internal market, but has recently come under strain because of growing integration in key areas of European banking and capital markets and cross-border risk exposures. Indeed, the financial crisis demonstrated the cross-border nature of systemic risk in global as well as EU financial markets through, for instance, counterparty exposures in the money markets and disruptions to the cross-border operations of many large banking groups and financial conglomerates. The crisis demonstrated the inadequacy of the EU's existing supervisory and crisis management framework.

As a reaction to these shortcomings, the European Commission proposed four regulations on September 23, 2009. One regulation proposes to create a European Systemic Risk Board (ESRB), and the other three regulations propose the creation of a European System of Financial Supervisors (ESFS) consisting of three new EU financial supervisory authorities, namely the European Banking Authority (EBA), the European Securities Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

Under the proposal, the ESRB would monitor and assess systemic risks in respect of individual banks and the whole European financial system. The ESRB would also issue recommendations and warnings to countries or financial groups or other concerned entities and would report all recommendations and warnings to the Council of Ministers. Moreover, it would devise specific follow-up procedures and incentives to follow its recommendations. Although the ESRB would consist of around 60 members (representatives and officials of EU agencies and member states' regulatory authorities) and might, therefore, appear to be a vast and hardly operational institution, its day-to-day functions would be exercised by a much smaller Steering Committee which would have the main responsibility of collecting and assessing data and reporting to ESRB board members. The ESRB would not have legal personality, nor would it exercise legally-enforceable powers, thereby enhancing its institutional flexibility. ***The ESFRC considers the creation of the ESRB as an important step in the right direction and recommends having it adopted at the ECOFIN Council.***

Of course, creating a new institutional structure is not an aim in itself. It serves the purpose of leading to better decisions and policy actions. Therefore, it is imperative that the ESRB - as well as relevant other existing institutions - has the information available that it needs for performing its function, that this information is comprehensive, reliable and timely. The current crisis has shown that in many cases the information required for sound decisions has been unavailable. There is an urgent need to prevent this from happening again.

The ESRB should collect, processes and disseminate the information required to anticipate a financial crisis and, in case a crisis has already become acute, to counteract it in an appropriate manner. The envisaged structure is very similar to the "European

Observatory of Systemic Risk"[1] which was already proposed by the ESFRC in a statement in October 1998; and what it produces should be called a "Risk Map"[2].

The new structure should in the first place provide information concerning the financial and risk-related relationships that exist between different financial institutions and thus their relatedness and the potential of contagion resulting form relatedness. Moreover, it should also include information concerning credit relations to non-financial entities as well as a full list of outstanding securities. It is already difficult to have a complete picture of the "primary" exposure based on who has lent how much to whom. However, the web of lending relationships would today no longer provide a full picture of financial relatedness and financial risk. One needs to also know how much risk individual financial and non-financial institutions have shifted to other institutions and how much risk they have taken over form others by using financial instruments like CDOs and ABSs.

The entire set of these different information it provides should permit to answer questions such as: which institutions have which kind of exposure to which other institutions? How high is their total exposure to those other institutions which one might call systemically relevant?

All of this information should be condensed in such a way that it can be linked to what may be presumed to be major macroeconomic risk factors so that it can serve as a means of reacting promptly to a crisis situation, and it should be processed in such a way that it can easily be communicated to all national and international authorities that are eligible to receive this information.

It would clearly be desirable to have this information available for the whole international financial system, as has been advocated in a recommendation which was prepared by the Issing Committee in March 2009 for the London G20 meeting. However, since this broad coverage may be very difficult to achieve for political reasons, we strongly recommend that the first steps to monitor systemic risk should be undertaken at the EU level.

European System of Financial Supervisors

The ESFS would consist of a network of member states' supervisors that would operate within three different European Supervisory Authorities (ESAs) with responsibility for banking, insurance and securities markets, respectively. The ESAs will have responsibility for devising a harmonised rule-book and technical standards for the application of EU financial legislation. The institutional structure of the ESFS builds on the Lamfalussy framework that in turn relies on member states exercising ultimate legal competence to supervise financial markets. The ESAs would facilitate the exercise of shared and mutually reinforcing responsibilities between member states' supervisors and the ESAs, performing specifically delegated tasks, such as mediating disputes between supervisors and, if necessary, resolving disputes. Their most important immediate responsibility would be to formalise the operations of the colleges of

[1] "EMU, the ECB and Financial Supervision", ESFRC Statement No. 2, Frankfurt, October 19, 1998.
[2] "New Financial Order – Recommendations by the Issing Committee", Part II, March 2009.

supervisors which presently oversee the cross-border operations of Europe's largest 50 or so banks and other financial institutions.

The proposal to create ESAs has been criticised on the grounds that their mediation and conciliation powers may infringe the fiscal sovereignty of member states. However, these concerns are exaggerated as the ESAs will only be able to resolve disputes and devise rules and technical standards for national supervisors based on existing EU financial legislation. Regarding crisis management, the fiscal safeguards provision of Article 23 of the ESA regulations does not permit the ESAs to take any measures that would require a member state to make fiscal expenditures (i.e., bank bailouts). The fiscal safeguards provision also applies under Article 11 regarding the authority of the ESAs in resolving disputes between member supervisors. The exercise of ESA powers was also criticised on the grounds of the so-called "Meroni" doctrine of the European Court of Justice that prevents EU institutions from delegating powers to the ESAs which they themselves do not have. **However, the ESFRC also considers that this criticism is not justified in legal terms, since the European Commission already has the competence to adopt implementing rules for EU financial legislation, nor important from a political perspective. Thus the proposal seems to be useful, though to a limited extent.**

In addition, these proposals for an ESRB and ESFS could potentially change the role that EU member states play in international standard setting bodies and the G20. Under the Commission regulations, the ESRB would interact with global macro-prudential risk bodies, such as the Committee on Payment and Settlement Systems and the Committee on the Global Financial System, and would contribute to the IMF's surveillance operations. Similarly, the ESFS's three financial authorities could potentially represent Europe in the deliberations of international standard setting bodies, such as the Basel Committee. The involvement of European institutions in these international bodies could enhance the effectiveness of Europe's role and influence in global financial standard setting.

All in all, the proposals to create the ESAs should be welcomed because the existing EU treaty framework does not permit any further institutional consolidation of financial supervision (except for Article 105.6 with regard to the ECB). Despite the potential legal challenges on "delegation of power grounds", the exercise of financial supervision will remain decentralised and based at the member state level.

The main objection to the proposal to create the ESFS and the ESAs is on another level. In our opinion this reform of the EU supervisory structure does not go far enough. In view of the crisis experience, it seems highly recommendable to centralise some supervisory powers more than the current proposal does. For the 50 or so largest banks and other financial institutions, which have extensive foreign operations, branches and subsidiaries, it would make much more sense to have one European supervisory authority. The reason for this is not only that it would be extremely difficult for national supervisors to obtain a clear picture of these institutions and their operations, but even more because their potentially risky operations may create significant cross-border externalities, which makes supervising them solely by one national supervisor suffer from a serious incentive problem. However, at present further consolidation of supervision within the EU would not be compatible with the EU Treaty. This limitation

has to be accepted at the moment. ***However, we recommend changing this situation on a political level soon by amending the Treaty to allow this step to be taken***.

Moreover, simply creating new institutions is not enough. The EU should pay as much attention and devote as much energy to substantive issues as it currently devotes to institutional issues. Among the main substantive issues that have been brought to the fore by the crisis are issues of crisis prevention and crisis management, which should also be very high on the agenda of the new ESAs that are now likely to come into existence.

Beyond Supervision: Crisis Management and Insolvency Procedures

Supervision and crisis management are parts of a seamless process. A healthy institution can quickly turn into an unsound one, which inevitably will lead – if conditions further deteriorate – to crisis management. Early intervention by the supervisor, linked to some threshold ratios of capitalization or to indicators of liquidity and sound banking, resolution of a crisis in a financial institution and, ultimately, reorganization and winding up of an insolvent one could be partly overlapping stages, going well beyond supervision proper, but clearly a process into which national supervisors have a key role in designing. The European Commission has recently published a Communication, "An EU Framework for Cross-Border Crisis Management in the Banking Sector", which makes the link from supervision to crisis management, and we shall return to this Communication in a later statement. Here, we confine ourselves primarily to the observation that the new framework for more intensive coordination between national supervisors in the ESFS should accelerate the spread of rules and good practices with respect to these broader areas of concern in the financial sector.

Early intervention when a financial institution reaches a capital threshold is a sensible approach that could be adopted at the national level and harmonized at the European and possibly also at the international level. The need for legal certainty and transparency suggests the need to adopt some mandatory trigger ratio for intervention that, no doubt, will focus the minds of bank managers, and will influence their incentive structure. As the ESFRC has argued in several previous statements, early intervention mechanisms (such as the Prompt Corrective Action rules in the US) are only effective if they are enshrined in the law, in particular the mandate to initiate early closure when the bank still has capital. Since early intervention reduces costs to taxpayers, a special resolution regime, like the SRR in the UK, is highly desirable.

Firm specific contingency planning, including "living wills", can facilitate an *orderly resolution* (as opposed to a chaotic one) and can act as a complement to early intervention procedures, as well as a mechanism for ex ante burden sharing. Living wills also address the issue of multi-level governance since they can combine the national, the European and the international dimensions. By preparing an institution's own funeral, a living will can help avoid the chaos that would surely ensue in the event of failure, given the tangled web of counterparties and derivative contracts of many banks nowadays. If troubled institutions expect governmental assistance, bank managers will have little incentive to pre-arrange an orderly resolution and market discipline will

be distorted. Living wills are currently under consideration in the UK with some FSA officials in the forefront of this debate.

Authorities should impose a requirement that all cross border banks draft a contingency plan outlining what they would do if they came under stress, including the eventuality of *insolvency*. This should include a recovery (capital and liquidity) plan and a resolution plan (the "terminal" living will). The recovery liquidity and capital plan would disclose which businesses or subsidiaries banks might be sold to third parties and outline how an institution would plan to wind down its trading book over a period of say 60 days. The contingent resolution plan, which has been likened[3] to the plan electric utilities develop in order to disconnect a power plant from the grid without bringing down the grid and with minimal disruption to consumers, would provide the information the authorities need to proceed to carry out an orderly resolution, in particular with regard to how to 'unplug' the bank from the payment, clearing and settlement infrastructures.

Critics of living wills - many predictably from the banking industry - claim that they might imply a return to a world of national markets in order to make things simpler for the authorities. Others claim that such wills may refrain a bank from entering into new lines of business or expand its operations. However, dealing with the too-big-to-fail problem or too-interconnected-to-fail problem by reducing the advantage of being big (or complex) can be construed as an advantage.

[3] See, for example, the presentation by Thomas Huertas on "Too big to fail, too complex to contemplate: What to do about systemically important firms" at a London School of Economics conference on September 15, 2009.