FINANCIAL REGULATION

What if the New Financial Supervision Framework Proves Insufficient?

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The financial crisis has underscored the need for effective financial supervision. The crisis demonstrated that supervision serves not only to verify whether financial institutions apply the rules, but that it also preserves the stability of our financial system and the economy at large.

Despite its crucial role, pre-crisis financial supervision proved inadequate. Therefore, the European Union (EU) committed itself to a reform of its financial supervision framework. The resulting legislative changes fully entered into effect in 2011.

This contribution will start with a sketch of pre-crisis financial supervision, followed by an overview of its inadequacies. Subsequently, the post-crisis reform will be discussed. As we will argue, the resulting supervisory framework is not all that different from the previous one. As a consequence, the adequacy of the framework is all but certain. If it were to fail again, the remaining policy options might prove to be most uncomfortable. This should lead the Trio Presidency to do its utmost to get the supervisory framework off to a good start and to carefully follow up its functioning. If needed, the EU should not shy away from early reforms.

Pre-crisis financial supervision

The EU financial framework has been characterised by two interrelated principles: minimum harmonisation and mutual recognition. Both are well established in EU law. For the financial sector, it implies that minimum EU rules allow a financial institution duly licensed in a Member State to provide its services in the rest of the Union without being subject to supplementary requirements.

The legal framework resulted in home country supervisory control. Such supervisory control implies that a financial institution is supervised by the Member State where it is licensed. This includes the supervision of cross-border and branch operations. For example, the French supervisor supervises a French bank's branch in Austria, as well as its cross-border operations in Belgium. Things are different when a financial institution sets up a separate legal entity in another Member State, referred to as a subsidiary. As a subsidiary is conceived and licensed as a separate financial institution, it is supervised by the country in which it is established. Nonetheless, the European harmonisation process has facilitated the setting up of subsidiaries.

Home country control significantly reduces the supervisory role of the host country, i.e. the Member State where the financial institution provides its services. The supervisory powers of the latter do not stretch far beyond the supervision of a branch's basic liquidity provisions and the collection of information for statistical purposes. While Member States may not have liked giving up on supervision of foreign branches, this was inevitable if a Single Market in financial services was to be created *without* the transfer of financial supervision to the EU level.

Nonetheless, policymakers realised that mere home country supervision was inadequate. The continuous integration of the European financial sector and the subsequent emergence of large, multinational financial institutions have rendered national supervision more and more obsolete. Financial supervisors are increasingly required to take into account operations which stretch beyond their national borders. To facilitate a cross-border vision, consolidated supervision has been introduced for multinational financial institutions. Such consolidated supervision takes into account a financial institution's overall operations.

In addition, supplementary arrangements allowing for cooperation between national supervisors have been adopted in the form of both EU legislation and multiple Memoranda of Understanding. Despite these arrangements, cross-border supervisory cooperation remained of a non-binding nature.

At the EU level, a Banking Supervision Committee was created inside the European Central Bank (ECB). The Committee (still) serves as a forum for information exchange between national banking supervisors. Furthermore, it is tasked with analysing and ensuring the stability of the financial system. Apart from the ECB's Banking Supervision Committee, three so-called Lamfalussy level 3 Committees played a role in pre-crisis financial supervision. The three Committees grouped the national supervisors and covered respectively the banking sector, insurance and occupational pensions firms, and the securities sector[1]. Their tasks expanded over the years, but like the ECB Committee, they lacked binding powers. Furthermore, their supervisory tasks were, at most, limited. As a result, the role of EU-level supervisors was largely limited to exercising basic monitoring tasks and to providing a forum for noncommittal cooperation.

1. These three Lamfalussy level 3 Committees were: the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and The Committee of European Securities Regulators (CESR)

The inadequacies of pre-crisis financial supervision

In retrospect, it has become clear that supervisors were unable to effectively detect, signal or mitigate the financial crisis. The pre-crisis supervisory system thus failed to perform its core tasks. A multitude of problems lies at the basis of this failure. On the one hand, supervisors carry part of the blame, as they neglected overall financial stability and overlooked potential risks. On the other hand, policymakers were insufficiently prudent and tended to neglect supervisory warnings.

More generally, the supervisory setup proved ill adapted to the integration of the financial sector. This is an international phenomenon, but was more pronounced in the EU, due to its Single Market and monetary union. While many EU financial institutions had outgrown their national borders, financial supervision had not. The provisions in place simply did not result in sufficient cooperation between national supervisors.

The limited supervisory reform

The recent reform of the supervisory framework was initiated in 2009 by the Report of the High-level Group on Financial Supervision chaired by Jacques de Larosière. In September 2010, the European Parliament and the Council reached an agreement on the legislative package. It entered into force in January 2011 and was widely welcomed as one of the main achievements of post-crisis regulatory reform. In essence, the crisis resulted in three major changes to the European financial supervision framework.

First, a macro-prudential supervisory body was created, named the European Supervisory Risk Board (ESRB). The ESRB's core task is to supervise the financial system, in order to prevent or if needed mitigate harmful financial system disruptions. Despite its important role, the ESRB's functioning is hampered by several constraints. The ESRB notably lacks coercive powers, has a bulky decision making body and depends heavily on the central banks. For the most part, the ESRB will have to rely on its reputation to influence the actions of policymakers and supervisors, which is far from evident given its challenging task.

As a second major change, three European Supervisory Authorities (ESAs) have replaced the aforementioned Lamfalussy Committees[2]. In contrast to the previous Committees, the ESAs have been endowed with substantial competences. They notably have a role to play in emergency situations and can counteract breaches of EU law, settle disagreements between national supervisors and adopt draft technical standards. In some cases, ESAs

2. These three ESAs are: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)

can even impose actions on national supervisors and individual financial institutions. These competences are however subject to several constraints, lengthy procedures and / or the go-ahead by an EU institution. This is likely to limit their application (draft technical standards being the exception). Furthermore, the actual supervisory role of the ESAs is limited to a small set of specific financial actors, such as credit rating agencies.

A final important change is the increased role of cross-border supervisory colleges. These bring together the different supervisors of the markets in which a given financial institution operates and are to strive towards a consensus on supervisory decisions. Some supervisory colleges had already been put in place before the crisis, but they proved too immature to play a substantial role when problems arose. As part of the post-crisis reform, supervisory colleges have become mandatory for all large financial institutions[3]. However, their weakness lies in the voluntary nature of cooperation. In the end, the home country supervisor remains in control. So merely making supervisory colleges mandatory will not necessarily render them effective.

In sum, the supervisory reform represents a significant evolution, but in no way a revolution. While it has led to an increased role for European supervisors, the heart of financial supervision remains unmistakably at the national level. The supervision of individual financial institutions is still a Member State competence and the principle of home country supervision is maintained. Consequently, only national supervisors combine both substantive supervisory tasks and binding powers. Moreover, the cross-border and EU-level supervisory bodies consist, for the major part, of national supervisors. These bodies are in no way supranational entities.

What if the reform proves insufficient?

While the post-crisis reform was substantial, it does not fundamentally alter the financial supervision framework. Consequently, financial supervision in the EU remains out of line with the integration of the sector it supervises. This is not necessarily incompatible with effective supervision, but it does require smooth and intense collaboration between national supervisors. Yet, this was not the case before the crisis.

As the asymmetry between financial sector integration and supervision persists, it is unclear whether the reform will remedy the previous supervisory framework's failings. Keeping this in mind, we need to consider the possibility that the post-crisis reform could end up being insufficient. If this were the case, the EU has in essence three policy options.

3. This reform was the consequence of a 2009 revision of the Capital Requirements Directive. See: European Parliament and Council, Directive, 2009/111/EC, JO L 302, 17 November 2009 (16 September 2009), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF

The first policy option implies a limited patch-up. This entails minor changes that limit the discretion of national supervisors, but without changing the basic supervisory set-up. The aforementioned asymmetry would hence remain. As the recent reform would have been unsuccessful, a subsequent similar reform would most likely lead to similar supervisory failings.

A second option can be referred to as the European solution and it implies a genuine EU financial supervision, both at the macro- and the micro-level. In terms of regulatory requirements, the change would not be tremendous, as most of financial regulations stem from the EU level. It would, however, result in a loss of national autonomy. To make matters worse, two major obstacles prevent a shift to EU-level financial supervision. First, current EU supervision is already on the edge of what is legally admissible. More EU supervisory powers could require a change in the EU's legal structure. Second, supervision is undeniably linked to financial sector crisis management. Yet, owing to its fiscal implications, financial sector crisis management is a Member State responsibility. It would be unacceptable for Member States to separate the two. As long as there is no EU crisis management or at least an effective European burden sharing mechanism, supervision will and should remain dominated by Member States. Opting for EU financial supervision would therefore require considerable political will, which seems currently absent.

Host country supervision constitutes the final policy option for the EU. Instead of aligning supervision with financial sector integration, policymakers could do the reverse. If the current supervisory system proves to contain essential flaws and if policymakers cannot agree on creating European supervision, the only option remaining is to reintroduce host country supervision. It would imply cutting back the Single Market and would thus lead to a less integrated financial sector. This does not seem an attractive prospect for policymakers.

While a patch-up is the most feasible policy option, it is equally the least likely to be successful. The two other policy options have a greater chance of success, but they are much harder to achieve. In addition, they would bring about consequences that Member States desperately seek to avoid.

Recommendations to the Trio Presidency

While imperfect and suffering from several of the pre-crisis framework's weaknesses, the renewed supervisory framework does have potential. Nonetheless, political will and effort will be required to exploit this. Here, the Trio Presidency can play an important role. It should do its utmost to get the supervisory framework off to a good start

The Trio Presidency should also closely monitor the functioning of the renewed supervisory framework. It should assist the Commission in preparing the future review. However, even with the support of the relevant actors, the supervisory framework can fail. If the Trio Presidency finds that the supervisory system remains subject to the same vital failures as before, it should speed-up the review process. If needed, it should even steer towards early reforms.

Although it is likely and understandable that, in case of renewed supervisory failings, minor changes will be considered first, they might prove insufficient to tackle the framework's essential flaws. Therefore, the Commission and the Trio Presidency should not only reflect on which reforms are feasible, but also –and more importantly– on what reforms are needed. Opting for significant reforms is far from evident and would imply controversial changes. Even so, the Trio Presidency should not shy away from such reforms. The importance of our financial sector and its stability should provide ample incentives to stay clear of pre-crisis business as usual. Only in that way can Europe obtain the effective supervisory framework it requires.