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Do the new financial regulations for the European Union offer good responses to the current crisis and forthcoming challenges?

Introduction

The financial governance, which comprises the regulation and supervision of the institutions, instruments and markets, suddenly disclosed severe flaws when it was faced with the recent financial crisis.

Indeed, national and global regulatory and supervisory systems revealed major weaknesses in almost every function : prevention, early detection, crisis management and ex post resolution. Crisis management nevertheless appeared effective, owing to a strong and historical public coordination at the highest level (G7, G20). However, those public actions increased the moral hazard problem. Official institutions nowadays consider the latter as unsustainable [BIS, 79th Annual Report].

At the global level, among the wide range of proposals under examination in the coordination institutions (G20, IMF, BIS, FSB, Basel Committee), the projects for reforms are oriented according to two major axes. On the one hand, macro-prudential supervisory institutions are being set up at the global (FSB), regional (EU) or national level (US, UK). On the other, the in-depth reform of the banking capital ratio (Basel II framework) would provide the micro-prudential tool in order to prevent or mitigate new risks, especially systemic ones.

As to the management of the recent financial crisis in the EU and the proposals for a new supervisory model, I laid stress one year ago, inter alia, on the following points [Perrut, 2009]:

- The severe lacks in the prevention and early detection of the crisis by the Authorities; this phenomenon is linked, among other factors, with the problems of asset valuation and the

interconnectedness of institutions, through off-balance-sheet exposures (on derivatives, e.g. CDS) and the highly complex products (such as CDOs of RMBS ; *see note*);
- The sharing of the functions of Lender of Last Resort (LLR) between State Members and the Eurosystem, the latter acting more as a Market Maker of last Resort (or "intermediary of last resort", BIS, 2009]) than as an LLR;
- The problem of moral hazard, dramatically increased both by the huge public support of the financial sector and by the strong action of the Eurosystem [BIS, 2009];
- Regarding the project of reforming the regulatory and supervisory model in the EU, we have to wonder if the new structures will lead, on the one hand, to the strong micro-regulation required by the situation and, on the other, to good coordination between the macro and micro level.

Following the main conclusions of the "de Larosière Group" report (Feb. 2009), the European Commission published a communication for a reform of the "European financial supervision" (May 2009), which was approved by the Ecofin Council and then by the European Council (June) [European Commission, 2009-2]. A package, comprising five legislative propositions was then published, 23 September. The Ecofin council agreed with those proposals in October and December and they are now being discussed by the European Parliament. This new architecture is expected to be in place by the end of 2010. Those proposals for a new supervisory framework are centred on two pillars [Commission, 2009-2&3 ; ECB, 2010]:

- a European Systemic Risk Board (ESRB), with the support of the ECB, to assess risks to the stability of the whole financial system, and to issue risk warnings and, when necessary, recommendations;
- a European System of Financial Supervisors (ESFS) for the supervision of individual financial institutions; it comprises three sector-oriented European Supervisory Authorities (ESAs): a European Banking Authority; a European Insurance and Occupational Pensions Authority; and a European Securities and Markets Authority.

This new framework, especially the second pillar, is closely linked to the process of building-up the Single Market of financial services. The latter faces serious and chronic obstacles (resulting chiefly from the lack of consistency in the implementation and supervision of the EU law in the different Member States). Moreover, the Single Market has to

address new challenges resulting from the consequences of the policies implemented to deal with the crisis (public support to the banking sector, Eurosystem action.)

Those EU reforms are also combined with those undertaken at the global level (new Basel framework proposal, December 2009; EU-US discussions about regulatory questions, e.g. accounting rules).

The question we now have to deal with is whether those proposals can prevent or mitigate a further crisis and ensure efficient management when such a crisis occurs. By way of a response, this paper will examine:

- The creation of the new body (ESRB) entrusted with the task of conducting the macroprudential approach to regulation and supervision to face the systemic risk : are the status and the mandate of this body sufficient to address such a challenge?
- The setting-up of the new body (ESFS), aimed at ensuring the micro-prudential supervision: are the three new authorities provided with sufficient powers and means to face the new obstacles raised by the crisis, in order to complete the Single Market?
- How is the European reform process going to deal with both the current global reforms and the EU-US regulatory competition?

1 - The new macro-prudential supervision level in the EU

Official reports recall that as far as we can foresee, there will be no second opportunity to take the systemic risk in the regulatory framework into account [IMF, 2010]. Do the tools proposed today in the EU fit with such a purpose?

11 - Concerning macro-prudential issues

Macro-prudential supervision cannot be separated from the concept of systemic risk. Numerous academic and institutional papers have dealt with this topic [ECB, 2009-2]. A short and general definition can be given here : "Systemic risk is intimately related with financial stability and could be defined as a risk of disruption to financial services that (1) is caused by an impairment of all or part of the financial system and (2) has the potential to have a serious adverse effect on economic activity" [IMF, 2010, ch. 2].

Macroprudential regulation and supervision can be defined as [Borio, 2009; Davis & Karim, 2009]:

- An approach focused on the financial system as a whole, rather than on individual institutions;
- A treatment of aggregate risk as endogeneous with regard to the collective behaviour of institutions (in contrast to that of individual institutions);
- An intention to limit the likehood and cost of financial system distress to limit costs for the real economy.

This broad approach of macroprudential supervision implies that the macroprudential oversight is necessary but not sufficient.

From an operational point of view, macroprudential policy should comprise four levels, in order to contain and manage financial crises, when they occur:

- A preventive level (with appropriate tools);
- A macroprudential oversight defined as "monitoring of conjunctural and structural trends in financial markets so as to give warnings of the approach of financial instability" [Davis & Karim, 2009];
- Emergency measures to face the crisis (non conventional monetary policy and lender of last resort actions);
- Resolution mechanisms to face the failure of systemic firms [IMF, 2010].

In the current financial landscape, the complexity of large financial firms has become one of the main problems that macro-prudential policy has to face. The BIS report highlights this phenomenon : "It is imposible for any individual to understand what all the parts" (i. e. the hundreds of subsidiaries of a large, integrated institution) "of such an organisation are doing, much less how they will interact in response to a major event. Enterprise-wide risk management would seem to be an impossibility in such cases" [BIS, 2009, ch. 7].

12 - The EU framework for macro-prudential supervision

"The ESRB shall be responsible for the macroprudential oversight of the financial system within the Community in the EU in order to prevent or mitigate systemic risk…" [Commission E.C., 2009-2]. Its tasks include: (1) the assessment and monitoring for the entire financial system in the EU, (2) the issuing of risk warnings and recommendations,

if necessary, and (3) the monitoring of the follow-up actions to such warnings and recommendations [ECB, 2010-2]. The ESRB will have the ability to request the ESAs (at the micro-prudential level) to provide information or to request it at national level if the latter is not available.

Strong cooperation between the two supervisory levels (ESRB and ESFS) is expected and would be ensured by:

- the cross-membership of each body in the meetings of the other body (ESRB would include the three Chairpersons of the ESAs; the ESRB would participate as an observer in the meetings of the ESFS);
- the structuring of the interplay cooperation and information-sharing.

The main decision-making body of the ESRB would be the General Board, comprising 61 members, among whom, as voting members : the Governors of the EU national central banks, the President and the vice-president of the ECB, a member of the EU Commission and the Chairpersons of the three ESAs. In addition, a national supervisor per Member State would participate as non-voting members (art. 6). The ESRB is established on the basis of article 95 of the EC treaty and would not have legal personality.

13 - Discussion

As to the status and powers of the ESRB, the proposal explains the choice of the Commission: "given the wide scope and the sensitivity of its missions, the ESRB shall not be conceived as a body with legal personality and binding powers" [EC, 2009]. The ESRB is expected to draw its legitimacy from its reputation and from its composition. Indeed, it brings together mostly the national central bank (NCB) Heads, who use to deal with the inter-linkages between the financial system and the macroeconomic environment at the broadest level. De facto, the Governors of the NCB will have a strong voting-majority.

The non-binding warnings and recommendations issued by the ESRB will be made through the so-called "comply or explain" approach: the addressee must either communicate how the ESRB warnings or recommendations will be taken into account, or give the reasons why there will be no action in response. The addressees can be the Community as a whole, Member States, the new micro-prudential authorities (ESAs), or national supervisors. Thus the ESRB will not deal directly with individual institutions, which remain under the monitoring of the ESAs or national supervisors.

Comparisons. The creation of a new macroprudential supervisory body in the EU can be compared with the similar reforms in the US and in the UK. Such a comparison shows that *(see annex 1)*:

- it is not mentioned whether, in the EU planned body, or in the UK one, the systemic supervisor would be responsible for identifying systemic firms, in contrast with the US project. Indeed, in the current proposal for a reform in the US, the Financial services oversight council (FSOC) will have, under the US Treasury proposals, the authority to designate any financial firm as Tier 1 "financial holding company", i.e. financial firms considered systematically important [IMF, 2010 ; ECB, 2009-2];
- enhanced resolution mechanisms exist in the UK and the US proposals, in contrast with the EU, where such mechanisms are not mentioned;
- the scope of supervision and the limits to the lender of last resort functions are discussed in the US, in contrast with the EU or the UK;
- Supervision of individual institutions is left with existing microprudential regulators in the 3 proposals.

Thus, the mandate of the ESRB appears to be narrower than that of the new body proposed in the US and, regarding resolution mechanisms, than the UK one.

The moral hazard problem has even worsened since the crisis, due to the joint commitment of the G7 Head of States to prevent any bankruptcy of systemic institutions after the failure of Lehman brothers. In the US, for instance, the Too-big-to-fail doctrine has been effective and led to the rescue of large insolvent institutions while more than 150 non-systemic banks collapsed without any help. Therefore, the public action aimed at rescuing systemic institutions in the major countries led to a situation where "despite the nearly universal concern over the mere existence of institutions that are to big to fail, short-run government actions are increasing financial sector concentration and adding to systemic risk" [BIS, 2009].

IMF criticisms of the current reforms. According to the IMF, the current reforms do not take into account the incentives of the supervisors, and chiefly their "regulatory forebearance incentives" to keep institutions afloat, especially systemic ones, when they should be unwound. Such behaviour would result, on the one hand, from the belief

that such institutions can recover with a temporary help, and on the other, from the fear of contagious effects [IMF, 2010].

According to the IMF vision, it is necessary to address the problem at its very roots. The macroprudential policy should comprise preventive instruments in order either to limit the systemic importance of institutions or to correct their systemic effects. Regarding this issue, several possible tools are under consideration by the Financial Stability Board, among which :

- Additional capital requirements linked to systemic risks ; these surcharges would be calibrated in relation to an institution's contribution to systemic risk;
- Taxes or levies to pay for costs of resolving Too-Important-to-fail (TITF) entities;
- Limits on market share or asset size; according to the IMF, "addressing TITF banks is critical for restoring market discipline and insulating sovereign balance sheets" [IMF, 2010, ch. 1.] This question is raised straightforwardly by the BIS: "…in the future a financial firm that is too big to fail or too interconnected to fail must be too big to exist" [BIS, 2009, ch. 7];
- Restrictions on activities (concerning chiefly the own-account proprietary trading, according to the "Volcker rule").

Thus, given the last proposal of the Basel Committee, we cannot fail to observe that the solution of the macroprudential problems in EU is to be expected both at the international and at the microprudential levels. The chief measure under discussion concerns the enhancement of the Basel II framework in order to prevent the systemic risk and the procyclical effects of the current standard [BCBS, 2009-3].

2 - Micro-prudential supervision: the objectives are closely linked with financial integration

21 - Objectives and scope

After the serious risks created by the financial crisis to the stability of the internal market, restoring the stability of the financial system was an "absolute prerequisite" for preserving coherence in the internal market. Reciprocally, more integrated markets offer better opportunities for financing and thus help to improve the capacity of the economies to

absorb shocks. "Financial integration and stability are therefore mutually reinforcing." [[Commission E.C., 2009-3, Explanatory memorandum, 4].

The final objective addressed by the reform is to link up national supervisors in a strong Community network in order to ensure a stable and single EU market for financial services. This network would work in accordance with the principle of subsidiarity, which means that the day-to-day supervision of individual entities would remain at the national level, under the monitoring of national supervisors.

The proposal for this regulation setting-up the ESFS's ESAs gives us an interesting definition of the scope which would be taken into account by micro-prudential supervision. "The objective of the ESAs shall be to contribute to:

- (i) improving the functioning of the internal market, including in particular a high, effective and consistent level of regulation and supervision;
- (ii) protecting depositors, investors, policy holders (…)
- (iii) ensuring the integrity, efficiency and orderly functioning of financial markets;
- (iv) safeguarding the stability of the financial system, and,
- (v) strengthening international supervisory coordination" [EC, 2009-5, Explanatory memorandum, 6.1].

22 - The framework

The three new authorities (ESAs), sector-oriented (banking, insurance and occupational pensions, securities and markets), will be founded through a transformation of the existing "Level 3 committees" (according to the new comitology called the Lamfalussy process.) In addition to the existing tasks those bodies will chiefly carry out the following activities [Commission E.C., 2009-3; ECB, 2010-2]:

- Issuance of binding and non-binding rules (also with the view of creating a single EU rulebook);
- Promotion of a consistent application of EU law;
- Binding mediation in the case of disagreements between national supervisors;
- Promotion of efficiency across colleges of supervisors, whose task is to ensure the monitoring of cross-border institutions;
- Imposition of common actions by supervisors in a cross-border emergency situation;
- Establishment and management of EU supervisory databases.

The Board of supervisors is the main decision-making body of the ESAs. It shall be composed of the Head of the relevant national supervisory authority in each Member State, as a voting member. In addition, the Chairperson of the respective ESA, one representative from the Commission, the ESRB and the two other ESAs would participate as non-voting members.

The ESAs are entrusted with exclusive supervisory powers over entities with Community-wide reach, according to the legislation. [Commission E.C., 2009-3, art. 6].

A so-called Omnibus directive proposal outlines the necessary changes to sectoral directives in order to make them consistent with the new supervisory set-up [ECB, 2010].

23 - Discussion

The micro-prudential supervision in the EU is thus managed by three kinds of bodies : the 3 new ESAs, the national supervisors and the colleges of supervisors for cross-border institutions.

Should the three new authorities (ESAs) be separated and sector-oriented? In spite of several criticisms expressed by professionals against such a separation, we do consider that strong arguments exist for such an organization:

- Each business (bank, insurance, securities and markets) is ruled by specific laws and supervisory processes;
- Such a separation allows better cooperation of the regulatory and supervisory levels (2 and 3 in the Lamfalussy process) with the EU legislative institutions and the national decision-makers and supervisors in each financial business;
- Despite the example of A.I.G, which is very specific, insurance is not to be seen as intrinsically subject to systemic risk, in contrast with banks, closely controlled by central banks, provided with tools to fulfil a Lender of Last Resort function.

Legal and operational issues. In contrast with the ESRB, the new ESAs are created with legal personality (Art 3) and are entrusted with binding powers (Art. 6). National competent authorities (NCA) as well as individual institutions may be concerned by such binding powers.

Regarding a NCA, the ESAs have the power to take an individual decision (which is a legal binding act, among the different EU legal instruments) in emergency situations (Art. 10) or to settle a disagreement between competent authorities (Art. 11).

As to individual institutions, the procedure would comprise several steps. The ESA may investigate any incorrect application of Community law. Following such an investigation, the ESA can address to the competent authority a recommendation setting out the measures that are necessary to comply with Community law. If the competent authority does not comply, the Commission may take a decision requiring such an action. If this decision is not applied, the ESA has powers to take an individual decision addressed directly to an individual institution concerned by the decision of the Commission.

The mandate of the new authorities (ESAs) appears to be very wide. Indeed, their mandate adds a set of new responsibilities to the already important existing tasks. Therefore, we are bound to wonder if the means put at their disposal as well as their composition (a college of 27 voting members) would allow them to comply with their tasks in satisfactory conditions.

Consistent application of EU law and common supervisory practices. Those new authorities are expected to promote consistent application of Community legislation and common supervisory practices. Indeed, in spite of several regulations aimed at strengthening the Level 3 committees since their establishment, between 2002 and 2004, divergent implementation of EU laws and different supervisory practices can be observed among Member States.

Such a situation results from several obstacles. On the one hand, some discretion can be left by the EU directives to Member States for the transposition into the national legal framework, and additional measures can be allowed at national level, according to the so-called principle of minimum harmonization. On the other hand, divergences can be observed in the supervisory practices, resulting chiefly from insufficient cooperation and information sharing between national supervisors. This situation leads to higher compliance costs for cross-border institutions which have to deal with a different situation in each country [ECB, 2010].

Financial integration: new obstacles, new challenges. In addition to the well known problems faced by EU decision-makers over the last 20

years to complete the Single Market of financial services, the recent crisis has brought new challenges:

- **The question of cross-border crisis management** : important work is being done by EU institutions in order to provide a clear framework for such situations. In the latter, the new authorities (ESAs) will have to share responsibility with the ad hoc colleges of supervisors. When disagreements appear between host and home supervisors, we may well wonder if the new authorities would have real powers to solve those conflicts.

- **As to public interventions in the financial sector**, we can observe ex post (according to the EC data, Sept 2009) that the effective intervention has amounted to 12 % of the EU GDP. We could discuss the principle of the adding up different kind of actions which cannot be compared with each other (guarantees granted and capital injection, for instance.) As a consequence, a more precise analysis would be necessary, but we cannot fail to observe great disparities between the countries regarding the effective public intervention (as a % of the GDP) :
    - On the one hand: UK: 31 %; Belgium, 35 %; Netherlands, 24 %;
    - On the other: Germany: 6 %; France: 4 %.

  Moreover, public support has been extremely concentrated on a few institutions. Indeed, for the entire euro area, the three largest recipient institutions have absorbed about half the support extended across each type of measure [ECB, 2010-2].
  The differences in public commitment between the Member States lead to competition and exit strategy problems for the EU, regarding the single financial market.

- **"Regulatory bargaining" between the EU and the US.** Flaws in the accounting standards and disparities between the EU and the US have been observed in the context of the recent crisis. In response, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) set up the Financial Crisis Advisory Group in December 2008, aimed at advising the two boards on the standard-setting implications of the financial crisis [ECB, 2010-2].

In April 2009, the FASB amended the accounting rules in order to limit the impact of impairment losses on the profit and loss account (only the credit-related ones being recognized in the latter.) In response, both the ECB and the EU Commission asked the IASB to resolve this issue, which compromised the level playing field.
Two IASB proposals for changes in 2009 (on repurchase agreements and on classification and measurement of financial instruments) have been criticized by the Eurosystem which invited the IASB to intensify collaboration with the FASB, with the purpose of avoiding disparities between the sets of rules.
Thus, the IASB is asked by the EU institutions either to follow the regulatory forebearance process of the US FASB, or to mitigate proposals aimed at improving accounting rules if those create a disavantage for the EU.

Conclusion

The reform of the financial supervision in the EU is not to be separated from the international coordination aimed at providing the financial system with new tools to face financial risks.

Regarding **the macro-prudential level**, the EU supervisory reform calls for some remarks and raises questions. Firstly, we cannot fail to observe that the EU new body (ESRB) has no legal personality and that its mandate is rather narrow by contrast with the project of a similar body in the US. Secondly, we should wonder what the task-sharing between this new institution and both the ECB (or the Eurosystem) and the intergovernmental structures, which are decision-making bodies, would be when a major crisis occurs. Thirdly, the lack of prevention tools in the current reforms, both in the US and in the EU, is to be mentioned.

As to **the micro-prudential level**, after lengthy discussions, during several years, the new Authorities (ESAs) are at last entrusted with binding powers to solve specific cases. However, if we consider their wide mandate and their composition as colleges with numerous members (one for each member state), we are bound to wonder if those authorities would be able to fulfil their duties in the new context.

Indeed, in addition to old and unsolved obstacles, new challenges are to be faced on the Single Market, resulting either from the exit strategies (concerning chiefly the public support to financial institutions) or from the regulatory competition with the US.

At the global level, the main preventive tool under examination to address financial unstability would be found in the complete remodelling of the Basel II framework, which is hardly implemented today. The new proposal made last December by the Basel Committee, with a mandate from the FSB and the G20 is aimed at preventing the new financial risks which are not sufficiently taken into account in the present standard, especially systemic risk.

This projets of reform raise several questions. As we know, banks are the only institutions subject to the Basel standards. So how are new regulations to be set-up for non banking institutions (as insurance or hedge funds) ? Moreover, a regulatory competition problem appears, given the fact that the banking capital ratio is implemented according to different policies, in the US (where the scope of application is limited), by contrast with the universal application principle in the EU. Last, the future standard would be far more complex that the present one which is already highly sophisticated. If we consider that the consistency between the EU supervisors is far from being properly ensured in their day-to-day task, we cannot fail to wonder how, for the implementation of such a complex standard, a good cohesion could be ensured at the international level.

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Note : CDS : Credit default swap ; CDOs of RMBS : Collateralized debt obligation of Residential mortgage-backed securities.

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Annex 1

Systemic Risk Regulatory Proposals

	United States			
	House of Representatives	Senate	United Kingdom	European Union
Systemic risk regulator	Financial Services Oversight Council (FSOC)	Financial Stability Oversight Council	Council for Financial Stability	European Systemic Risk Board (ESRB)
Institutional arrangements	A council of Treasury secretary (chair) and heads of federal regulators; resources provided mainly by Treasury	A council of Treasury Secretary (chair) and heads of federal regulators and an independent member	A council of heads of Treasury (chair), Financial Services Authority, and Bank of England	A council of central banks and regulators; secretariat provided by European Central Bank
Powers				
Assessment of systemic risk	Yes	Yes	Yes	Yes
Making recommendations	Yes	Yes	n.a.	Yes
Identification of systemic firms	Yes	Yes	n.a.	n.a.
Rule making	No	No	No	No
Central bank in microprudence	Fed supervises all systemic firms regardless of their legal structure	Fed supervisory authority narrowed	No change	No change
Restrictions to lender of last resort	Determination by FSOC and consent by Treasury secretary required for section 13 (3)	Liquidity assistance under section 13 (3) limited to market-wide systems or utilities	No	No
Enhanced resolution mechanism	Systemic Dissolution Fund is to be established for systemic firms	Orderly Resolution Fund is to be established for systemic firms	Special Resolution Regime for major banks has been established	No

Sources: U.S. House of Representatives, *Wall Street Reform and Consumer Protection Act of 2009* (H.R.4173); U.S. Senate Committee on Banking, Housing, and Urban Affairs, Restoring American Financial Stability Act of 2010 (see chairman's marked text, March 2010); U.K., *Banking Act of 2009, Financial Services Bill* (introduced in the House of Commons on November 19, 2009); and European Union, proposals for regulation of the European Parliament and of the Council on Community macroprudential oversight of the financial system and establishing a European Systemic Risk Board.

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