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The road ahead after de Larosière

A study by Karel LANNOO,

Centre for European Policy Studies (CEPS), Brussels
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INTRODUCTION

The European Finance Ministers decisions of 9 June 2009, successively adopted by the European Council, broadly implement the proposals of the de Larosière Committee and the European Commission on European financial supervision, and provided the necessary detail. From 2010 onwards, a new structure should be in place to ensure more integrated European macro and micro-prudential oversight. The macro-economic risk council will be consultative, and will largely function within the context of the ESCB, hence not posing big implementation issues. The Authorities coordinating micro-prudential supervision will be established by the Council in the autumn, basically upgrading the existing Committees, but with a substantially increased workload, raising important structural and organizational issues.

Apart from the adaptation of the institutional structure, the EU is currently implementing a comprehensive regulatory response to the crisis, following at the same time a globally dictated agenda (G-20) and a single market set of measures. The latter results from inconsistencies (e.g. deposit guarantee schemes) and gaps (mortgage credit) in existing regulatory framework.

This workload interferes with important changes on the EU scene, which could delay the legislative process. A new parliament is coming into office, and will take some time to get its grip on the different dossiers. With more than 50% new MEPs and more than 100 important positions to be decided upon in the new EP, a fast track of new legislation cannot be expected. In addition, a new European Commission College will be appointed during the Summer, and a new work programme adopted. Moreover, the possible implementation of the Lisbon Treaty by the end of the year could result in further seismic shifts. Not an ideal context thus to push through an enormous legislative agenda.

I THE DE LAROSIÈRE AGENDA

The Council of finance (Ecofin) ministers of 9 June 2009 agreed upon a new structure for supervision in the EU. They agreed with the creation of four new entities, a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS), comprising three functional authorities. The Council conclusions describe in detail the framework and responsibilities of the new supervisory bodies. To implement both decisions still raises problems, of a conceptual nature for the ESRB, and of a more organizational for the ESFS.

The Ecofin Council stated in its conclusions that “regulation and supervision in Member States and in the EU must be enhanced in an ambitious way ensuring trust, efficiency, accountability and consistency with the allocation of responsibilities for financial stability, taking into account the responsibility of Finance Ministers.”¹ Ministers probably wanted to recall earlier discussions in the Ecofin on financial supervision in 2002, and remind the public that, because of the

¹ Council conclusions on Strengthening EU financial supervision, Luxembourg 9 June 2009.

accountability to taxpayers, they are in control.² The respect of fiscal sovereignty is further reiterated several times in the Council conclusions.

II THE EUROPEAN SYSTEMIC RISK BOARD (AND THE ECB) AT THE CENTRE

The ESRB will be at the centre of the new system, even if this body is only consultative. Its steering committee is composed of 8 persons, the 3 ESCB members (including the president of the ECB), the three chairs of the European Supervisory Authorities (ESAs), a member of the EU Commission, and the President of the Economic and Financial Committee (EFC). The dominance of the central bankers in the governance of the new structure is even clearer in the General Board of the ESRB, which comprises, apart from the Steering Committee members, all central bank governors of the EU 27. The creation of the steering committee, not foreseen in the de Larosière report, probably comes to meet the criticism that the ESRB would be too unwieldy to be effective.

The ESRB will rely on the analytical and administrative services and skills of and have its seat in the ECB, a well-reputed and established institution, and thus be controlled by the ECB. The Finance Ministers have only one representative in the ESRB. Hence, notwithstanding the declaration of the finance ministers that they want to be in the driving seat, the power at the centre is entirely with the central bankers.

The ECB had reacted against the establishment of the ESRC as a separate legal entity, which the European Commission initially proposed, and preferred the use of Art. 105.6 of the EU Treaty to confer macro-prudential tasks to the ECB/ESCB. However, as the latter requires unanimity in the EU Council – and therefore seemed very improbable – the ECB preferred the other option, but as a consultative body. “The establishment of the ESRC as an EU body with legal personality would create a separate EU quasi central banking institution with responsibilities that are overlapping with the financial stability tasks performed by the ECB/ESCB”, the ECB stated in a confidential note on the Commission’s working document on European financial supervision.³ A separate entity would become confusing and raise issues of representation and competence, it noted.

The ESRB should:

- define, identify and prioritise all macro-financial risks;
- issue risk warnings and give recommendations to policy makers, supervisors and eventually to the public;
- monitor the follow-up of the risk warnings;
- liaise with international and third country counterparts;
- report at least bi-annually to the EU Council and European Parliament.

The ESRB will strengthen the ECB role also in another sense. Through the ESRB, the ECB will have access to the micro-prudential information. Throughout the financial crisis, ECB officials criticised the lack of access to supervisory information of financial institutions. In its confidential memo to the Commission president, the ECB requested to collect the supervisory information:

² See conclusions of the Ecofin Council of May 2002.

³ ECB, The establishment of the European Systemic Risk Council, 24 May 2009.

“The ECB/ESCB should be provided with the task to collect and share macro-prudential and aggregated micro-prudential information (...) which is necessary for the performance of the tasks of the ESRC”.⁴ The Ecofin Council decided differently, however, stating that the “central European database should be established and managed by the European Supervisory Authorities.” But this information should be shared with the ESRB “subject to specific confidentiality agreements”, it was added.

Crisis management is not mentioned as a task of the ESRB, but of the ESFS in an exploratory way. This is a departure from the ad-hoc agreement which was reached in the European Council in October 2008, whereby the president of the ECB (in conjunction with the other European central banks) would form part of a financial crisis cell, with the president of the Commission, the EU Council and the Eurogroup.

The task is now essentially for the ECB to bring the ESRB into being. Although the ERSB can rest on a formidable back-office, conceptual challenges remain. Will they be capable of clearly identifying and reacting to a bubble amongst the hundreds of possible risks on the horizon? How will the boundary be drawn with the micro-financial tasks? The ECB needs to realize that the responsibility it takes in assuming this task could negatively impact its reputation in the future, and eventually its independence in setting monetary policy. It could also be recalled that the ECB already had a committee under its roof which assumed some of these responsibilities, the Banking Supervisory Committee (BSC). The discussion on this subject, which is also on in the US with the creation of a Systemic Risk Council, commands to move on with extreme circumspection.⁵ However, it seems that, because of these conceptual and institutional issues, the European solution of a purely consultative body is the right step forward.

III THE EUROPEAN SYSTEM AND FINANCIAL SUPERVISORS

The establishment of the ESFS is a daunting task. Unlike the ESRB, the Authorities can hardly rely on an existing structure, but almost need to start from scratch, or need to magnify the tasks currently performed by the Committees to an exponential degree. It is for this (and other reasons) that we recommended to establish these authorities under a single roof right away, to share as much as possible a common administration, and avoid unnecessary overlaps and confusing responsibilities. However, a single roof would have meant a single location, a Pandora's box which the EU Council preferred to keep closed, given that the Committees which form the basis of three future Authorities have their seat in the (business) capitals of the three most important member states, respectively Paris, London and Frankfurt.

The ESFS will:

- move towards the realization of a single rulebook;
- ensure harmonized supervisory practices;
- strengthen the oversight of cross-border groups and supervise pan-European entities;
- establish a central European database aggregating all micro-prudential information;
- ensure a coordinated response in crisis situations.

⁴ ECB, The establishment of the European Systemic Risk Council, 24 May 2009, p. 4.

⁵ On the US, see Emil Henry, Daunting decisions on a new risk regulator, Financial Times, 11 June 2009.

The three Authorities can be expected to be established as regulatory agencies under EU law, following Art. 95 of the EU Treaty. Although the Council stated that the choice of the legal basis has not been taken, the Commission proposed in its Communication Art. 95 of the EU Treaty, relating to adoption of measures for the approximation of legislation for the functioning of the internal market. As the agencies will work on the development of a single rule book to ensure uniform application of rules in the EU, they will contribute to the functioning of the internal market.

The use of Art. 95 has another advantage, in that the decision to establish the Authorities could be taken by qualified majority vote (QMV) in the EU Council. This compares to Art. 308, which requires unanimity. As some member states may not be so keen in delegating large powers to the Agencies, QMV would allow the European Commission to go for a broader mandate.⁶ On the other hand, Art. 95 requires co-decision with the European Parliament, which is not the case for Art. 308, implying that the decision process under Art. 95 may be longer. In any case, it is better to have an as unanimous approval as possible for such important decisions.

Much now depends on the precise elaboration of the mandate of the agencies in the Commission proposals, which the Ecofin Council expects in the early Autumn 2009 “at the latest”. Among the 28 EU regulatory agencies which exist at present, no general rules apply governing their creation and operation. They were more set up on an ad hoc basis, rather than via a coherent administrative and/or regulatory method. Consequently, large differences exist between them when it comes to their functions, organisational structure and funding provisions.⁷ Given the supervisory problems raised by the crisis, a precise proposition on the mandate, tasks, organization, decision making, funding and accountability of the new agencies is crucial.

As compared to the tasks of the “Level 3” Committees (3L3), as created by the 2001 Lamfalussy report, the workload has been magnified. Whereas the 3L3 had an essentially regulatory task – advising the European Commission on implementing rules – the new Authorities will in addition have many supervisory duties as well. The realization of a single rulebook and the consistent application of EU rules continues and extends regulatory tasks of the Committees. The Council conclusions mention in this regards that a mechanism should be developed to ensure more consistent application of EU law and a tougher sanctioning regime for cases of non respect. But the addition of supervisory responsibilities and the constitution of a central supervisory database constitute a new and heavy workload. This comprises a.o.:

- coordinating the supervisory analyses of financial groups;
- ensure consistency in supervisory outcomes across financial groups;
- participate and eventually mediate in supervisory colleges;
- supervision of pan-European entities;
- develop common training for supervisors.

⁶ The basis could be challenged by the member states. In 2004, the UK challenged the choice of Article 95 EC as the legal basis of the European Network and Information Security Agency (ENISA) before the European Court of Justice and stated that Article 308 EC was the only possible legal basis. The Court ruled that the use of Article 95 EC was appropriate for ENISA, as it constituted a part of the normative context directed at completing the internal market in the area of electronic communications. See Andoura and Timmerman (2008), p. 7.

⁷ Andoura and Timmerman (2008), p. 9.

The extensive supervisory tasks may give rise to problems with member states, and raise the question of the powers of the agency. The Authorities could, according to Court jurisprudence, never have more powers than the delegating authority has under the EU Treaty.⁸ Some of the issues raised above could be on the borderline between what is a task for the EU under the Treaty, and what remains a member state competence. In addition, the question can be raised who is in charge for enforcement. Under the Lamfalussy report, the hardly mentioned Level 4, enforcement, was a Commission competence, whereas under the new proposals on the table, the ESAs would share enforcement competences with the EU Commission.

A related issue is the degree of independence of the ESAs. The Council conclusions reiterate that the ESAs should be independent vis-à-vis the national authorities and vis-à-vis the European institutions. On the other hand, the decisions which they take should not impinge on fiscal responsibilities of the member states. A problem in this regard is the supervision of pan-European entities. Recent EU decisions have already anticipated the creation of the ESAs. The recent regulation on credit rating agencies gives the Committee of European Securities Regulators (CESR) the authority to register CRAs according to the new rules. CESR should receive the power to decide on applications for registration and inform competent authorities in all Member States. Other possible areas are central counterparties and settlement entities. The Ecofin Council conclusions note that some member states do not agree with this approach, since it could affect national fiscal responsibilities. The same reasoning applies for crisis management, where it seems that ESAs will only have a limited responsibility, for emergency *regulatory* decisions, such as short-selling restrictions for example.

The Council is less clear than the European Commission on the governance of the ESAs than on the ESRB. It only states that there should be a Steering Committee of ESAs to reinforce mutual understanding and coordinate information sharing. This reinforces our view that the ESRB will be at the centre of the new supervisory architecture.

IV THE POST-CRISIS REGULATORY AGENDA

The legislation on the adaptation of the institutional structure will, for the new European Parliament, come in addition to post-crisis regulatory agenda. This agenda is driven by international (G-20) as well as European single market considerations. Some parts of this agenda have already been completed, others have just been initiated, or are still in the pipeline.

The crisis revealed important shortcomings in the regulatory framework, to the extent that a core principle of the single market, the single passport and home country control, was put into question. To restore this principle, the European Commission will have to engage in moving towards a much higher degree of harmonisation of deposit protection forms of protection: the protection of the home country (head offices and branches, free provision of services), the host country (in case the bank is a subsidiary), and the home country topped up with host country level of protection (in case the level of protection for a branch in the host country is lower than the home country). Until the crisis broke out, the large majority of consumers were not aware of the large differences in protection schemes. In the midst of the crisis, the Member states provisionally agreed in the EU Council to increase the minimum levels to €50,000, but did not

⁸ See Meroni Case, as quoted in Andoura and Timmerman (2008), p. 12.

change home-host system, nor the method of funding or the statute. The European Commission will need to report before the end of 2009 on how to reform the system in the long term.

Other elements will need to be reformed to get consumers back on board of the single market. Mortgage lending, for example, is not subject to any degree of EU harmonization, whereas (short term) consumer lending is. Although mortgage lending is about 9 times more important than other forms of consumer credit, a consultation in 2007 concluded that the different forms of national legislation seemed to work well enough, and that there was no need for European harmonisation. However, principles such as responsible lending, loan-to-value ratios could well be harmonized and enforced at European level, as lax standards in one member states has European-wide implications.

V STATUS OF POST-CRISIS FINANCIAL SERVICES LEGISLATION

| Measure | Purpose | Status |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------|
| Depositor protection schemes | Increase minimum level of protection to €50,000 | Adopted October 2008, report by end-2009 |
| Credit rating agencies | Introduce single licence | Adopted April 2009 |
| Amendments to capital requirements directive (CRD) <ul style="list-style-type: none"> - securitization - executive remuneration - trading book and complex financial products | <ul style="list-style-type: none"> - 5% capital charge - extra charge for high pay packages - higher capital for trading book | <ul style="list-style-type: none"> Adopted April 2009 Consultation (April 2009) Consultation (April 2009) |
| Hedge funds | Regulate non-regulated segment of fund industry | Commission proposal (April 2009) |
| Prospectus directive | Possible review | Consultation (January 2009) |
| Investor compensation schemes | Possible review | Consultation (February 2009) |
| UCITS IV | Implementing measures | Consultation of CESR (March 2009) |
| Market abuse | Improve and simplify directive | Consultation (April 2009) |
| Depositaries of funds | Segregate funds from depositaries | Consultation (May 2009) |
| OTC markets | Transparency, mandate some central clearing | Consultation (June 2009) |
| European Systemic Risk Board | Identify macro-financial risks | Regulation (September 2009) |
| European Banking Authority | Coordinate banking regulation and supervision | Regulation (September 2009) |
| European Insurance Authority | Coordinate insurance regulation and supervision | Regulation (September 2009) |

| | | |
|---------------------------------------|----------------------------------------------------|-----------------------------|
| European Securities Markets Authority | Coordinate sec. markets regulation and supervision | Regulation (September 2009) |
|---------------------------------------|----------------------------------------------------|-----------------------------|

VI A FORCEFUL COMMISSIONER IN CHARGE

A pre-requirement to credible European agenda is a forceful and credible Commissioner in charge. The outgoing Commissioner for the single market McGreevy had by the end of his term lost all credibility. McGreevy's initial slogan was "regulatory pause" after the heavy Financial Services Action Plan which his predecessor Bolkestein had pushed through. The Commissioner gave priority to market-driven solutions, including self-regulation, before going for new regulation. Even in the first months of the crisis, the Commissioner hesitated to call for new regulation, for, for example, credit rating agencies or deposit guarantee schemes. He also did not dare to stand up against the predominant attitude in the EU Council of finance ministers that the crisis did not signify changes were necessary in the institutional structure of supervision. It is only by May 2008 that the Commissioner started to change his position and called for a regulatory response. Moreover, the initiative to establish the de Larosière Group in October 2008 was taken by the Commission President, not by Commissioner McGreevy.

Related to this is a possible re-distribution of the internal market portfolio, which could better be split up. Internal market is one of the cornerstones of the EU, which can better be the task of two or three commissioners. Financial services matters alone deserves a single commissioner, and this even more so for the next five years, when the Commissioner will have to push a heavy agenda through the EU Council and European Parliament, and take on additional responsibilities in the ESRC and ESAs. A forceful Commissioner will thus be extremely important for the Commission to regain the initiative.

CONCLUSION

The European Commission faces a difficult and tight balancing act in drafting the proposals for a new framework for EU supervision "by early Autumn 2009 at the latest". She will need to come forward with draft legislation laying down as clearly as possible the objectives, functions, organization, governance and funding of the new entities proposed by the de Larosière report. As the Commission will most likely follow the Art. 95 route, the Commission proposals will probably go as far as possible within the limits of the current EU Treaty.

The measures to be decided upon in follow-up to the de Larosière report come in addition to the consultations and proposals for new measures which the European Commission in involved in as a result of the G-20 commitment and the further completion of the single market. All these will have to be pushed through in a context of a new European Parliament and a new European Commission, which does not guarantee a swift decision process.

But will this enough to restore the single market? The financial crisis and the large state aid packages have forced banks to focus on their home market and reduce their activities abroad.

Market integration is declining and competition is diminishing. It will take time before the effects of the measures discussed above become visible.



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