ESTABLISHING A EUROPEAN FINANCIAL SUPERVISION

Summary

Over the last couple of years, there has been considerable debate on the need to “complete” the banking union, which quickly came to be seen as half-baked. In this debate, there has been little attention in this debate, however, to what is arguably the most glaring shortcoming of the banking union: the omission of shadow banks from the supervision mandate given to the European Central Bank in and through the Single Supervisory Mechanism (SSM).

The European Systemic Risk Board (ESRB) – itself restricted to monitoring – recently documented that Europe’s banking and non-banking financial institutions are as interconnected as ever (ESRB 2019). There cannot be any such thing as a completion of Europe’s banking union, we argue, without the establishment of formal European supervision of all non-bank financial institutions.

Looking to the future, we outline five different options for how comprehensive European supervision of shadow banking could be organised:

- Upgrading the mandate of the ESRB from monitoring to supervision
- Expanding the mandate of the SSM to include non-banking financial institutions
- Adopting a “twin peaks” model for financial supervision
- Creating one or two new specialised, supervisory bodies targeting shadow banking
- Establishing a European Financial Supervision Authority (EFSA)

The authors identify the last of these five options as the most promising because it would make the institutional set up for financial supervision more simple, would cover a broader range of financial institutions, including non-banks, and would allow for coherence and consistency in the execution of supervisory activities.

Establishing an EFSA – legally, organisationally and geographically separate from the European Central Bank (ECB) – would correspond to what has traditionally been known as the “German model” for dealing with the dual challenges of financial supervision and monetary policy (Goodhart and Schoenmaker 1995).

Mindful of the crucial member state politics of building a winning coalition behind such an initiative, we note this feature as a strength that could allow the EFSA to be located in Paris.

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1. INTRODUCTION

The recession caused by the corona lockdown has thrown the Eurozone into yet another existential crisis (Gros 2020; Münchau 2020). Matters of euro resilience are even more acute today than they were in spring 2018, when policy-makers and analysts first sounded alarm about the urgency of “completing” the banking union. In debates about what it would take to “deepen” the EMU – so that the euro becomes more resilient – a crucial topic has been missing, however. There has been only marginal and superficial attention given to the crucial issue of establishing comprehensive European supervision of all non-bank financial institutions, often labelled shadow banks.

When the establishment of a Single Supervisory Mechanism (SSM) was agreed by member states in October 2013 (to become operational a year later), it only included banks in its remit. This was in contrast to the situation in the US, where the Dodd-Frank Act had established the Financial Stability Oversight Council (FSOC), with an explicit mandate to supervise shadow banking institutions and prevent the build-up of systemic risk. In Europe, an agency dedicated to issues of systemic risk was created too, in the form of the European Systemic Risk Board (ESRB) (in 2010), but it was given authority only to monitor, not to supervise, the shadow banking sector, and hence was given no legally binding tools to combat systemic risk.

As we have described in detail elsewhere (Vestergaard and Quorning 2019), there is every reason to be concerned about the lack of European supervision over its shadow banking institutions. It is therefore of paramount importance that the new European Commission – in collaboration with member states and the new European Parliament – establishes effective European supervision of all non-banking institutions. This Policy Brief outlines five different options for approaching this task organisationally.

A key feature of debates about what the ECB could and should do is the discussion as to whether the proposed initiatives would violate the Treaties defining the perimeters of the ECB’s legitimate activities. In the case of financial supervision such an argument would not apply, however. The Treaty explicitly refers not to banks but to “credit institutions” and “other financial institutions” (Article 127(6) of the Treaty on the Functioning of the European Union), a concept that could easily accommodate most non-banking financial institutions (although insurance undertakings are exempt).

If the Treaties allow for the inclusion of non-bank financial intermediaries, one might ponder that maybe the decision to exclude them from the ECB supervision mandate simply reflected that regulators and policymakers were united in finding the inclusion of non-bank financial intermediaries irrelevant. There is ample evidence to the contrary, however. A letter sent in September 2012 from José Manuel Barroso, then President of the European Commission, to Martin Schulz, then President of the European Parliament, is indicative of attention to the issue at the highest echelons of European financial regulation. Barroso argued that it was important to consider “legislation to address systemic risks related to non-banks and shadow banking”, with explicit reference to the banking union (Barroso 2012).

In previous work (Vestergaard and Quorning 2019), we have identified four explanatory factors that may help understand why non-bank institutions were omitted from the SSM mandate and hence why European financial supervision remains fragmented and disjointed. Our discussion of the five different
options for remedying this predicament is informed and guided by our analysis of those four explanatory factors.

The remainder of our Policy Brief is organised as follows. First, we briefly summarise the four explanatory factors we have identified. Second, we outline the five main options for establishing comprehensive supervision of European finance. And last but not least, we identify what we believe to be the most promising of them, and reflect on a few core issues as regards the inter-state politics of establishing it.

2. WHY DOES EUROPEAN FINANCIAL SUPERVISION REMAIN FRAGMENTED AND INCOMPLETE?

In previous work (Vestergaard and Quorning, 2019), we have identified four explanatory factors that all contribute to understanding why the SSM mandate excluded non-banking institutions and hence also why European financial supervision remains fragmented, incomplete and weak:

Positive reframing of shadow banking
In parallel with the negotiation of the SSM mandate, shadow banks were undergoing a dramatic ideational reframing, from being outright dangerous to being absolutely essential for economic recovery, not least as a potentially crucial funding source for SMEs. On account of this positive, ideational reframing, and its centrality to the new European discourse on economic recovery by the Juncker Commission, it did not seem important or even desirable to subject shadow banks to pan-European supervision.

Avoiding disruption of prior decisions and institutional constructs
With the establishment of ESRB as a part of the initial policy response to the financial crisis, there was thus already a designated institution for oversight of shadow banks, and the decision had already been taken to monitor but not to supervise. The omission of shadow banks from the SSM mandate reflected a preference for avoiding the disruption of prior decisions and institutional constructs pertaining to Europe’s shadow banking institutions. Or to put it differently: for reasons of path-dependency, the inclusion of shadow banking institutions in the SSM mandate was simply not considered.

Focused on breaking the doom loop, forgetful of systemic risk
The SSM was conceived and negotiated in the context of the launch of the banking union, itself a response to the sovereign debt crisis. In this endeavour, the predominant concern was to break the ‘doom loop’ between banks and sovereigns, and consequently there was a certain forgetfulness of issues of systemic risk at play when the banking union was conceived and negotiated. The SSM mandate reflected this specific political context. It was a logic of political appropriateness in response to the sovereign debt crisis that defined the perimeters of the SSM mandate. The supervision pillar of the banking union was thus set up to focus on banks, not a plurality of other financial institutions.

Too much of a bad thing? The ECB’s reluctance
Shadow banks were deliberately excluded from the scope of the SSM mandate because the most powerful actor, the ECB, did not want them included. The ECB feared that the formal responsibility of combating systemic risk, which would come with a supervisory mandate for non-banking institutions, could potentially compromise the ECB’s primary mandate for price stability. It feared that taking on such a responsibility would make its currently somewhat weak financial stability mandate stronger in a manner that could complicate its dedication to the primary objective of price stability. All of these four explanatory factors complement a generalised preference in many member states to opt for limited rather than
Confronting the ECB’s austerity mandate
Vestergaard and Gabor

comprehensive reform whenever possible (Quaglia 2013, 24).

3. POLICY OPTIONS

There are five main ways in which the EU could choose to organise an effort to strengthen its supervision of non-banking financial institutions:

• Upgrading the mandate of the ESRB from mere monitoring to supervision
• Expanding the mandate of the SSM to include non-bank financial institutions
• Creating one or two new specialised, supervisory bodies targeting shadow banking
• Establishing a regulatory institutional set up following the twin peaks model
• Establishing a European Financial Supervision Authority

The two most straightforward options for strengthening European supervision of shadow banking would be either to upgrade the existing mandate of the ESRB so as to encompass not just monitoring but also supervision; or to expand the mandate of the SSM so as to include all financial institutions. However, a major problem with either of these options is that increasing the ECB’s formal responsibilities for financial stability would likely meet with intense internal resistance for fear of eroding the primacy of the ECB’s commitment to price stability. In the absence of a revision of the mandate of the ECB itself – formally putting financial stability and price stability on an equal footing – these two options do not therefore seem practicable.

A third option would be to create one or two new supervisory bodies that would target specific activities in the shadow banking sectors, where supranational supervision would be particularly important. For example, a European Repo Agency could be established to complement the supervisory work of the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). In many ways, such a mushrooming strategy would most likely be the path of least resistance. But it would also be the least compelling. The supervisory mandates of the existing European supervisory authorities (ESAs) are known to be weak and the danger is considerable that coordination efforts would be unable to compensate for the disadvantages of fragmented supervisory agency.

Implementing a new regulatory framework following the twin peaks model (Schoenmaker and Véron 2016) is a fourth option. The twin peaks model abandons the current sectoral model of supervision, to replace it with a dual structure where one institution focuses on the prudent supervision of financial institutions, and the other focuses on markets and business conduct. This model would be better fit for the institutional landscape of the financial sector today, where financial conglomerates combine banking and insurance undertakings (ibid.) As noted by Godwin, Howse and Ramsay (2017), however, the model entails risks of overlapping regulation and a lack of proper coordination. The twin peaks model thus replicates one of the main weaknesses of the current institutional set up.

This then leads us to the fifth option, of creating a new institution of financial oversight that would merge all the existing pan-European supervisory and monitoring agencies into one, organised as an independent institution, separate from the ECB. This model would bring the three existing ESAs – the European Banking Authority (EBA), ESMA and EIOPA – under one roof, in a merger with the SSM, the Single Resolution Mechanism (SRM) and the ESRB.
At first glance, this may seem the least realistic of the five options because of the considerable institutional shake-up it would entail. Nevertheless, it has several strong features that merit attention. First and foremost, it would bring an end to institutionally fragmented financial supervision, as well as a promise of enhanced supervisory coherence and consistency across various segments of European finance.

But even more importantly, perhaps, it would address a key problem that was exposed by the financial crisis, and that post-crisis reforms have still not tackled, namely “the complete lack of any clear institutional responsibility for overseeing the safety and soundness of the financial system as a whole” (Ferran and Alexander 2011, 18).

We fully recognise that such a radical change in the institutional structure of European supervision is not going to happen overnight, as institutional change is always difficult. On the other hand, the establishment of the banking union in 2012 demonstrates that major institutional innovation can indeed succeed when political circumstances are favourable. It would be unfortunate to dismiss a crucial debate on how to prevent a build-up of systemic risk outside the supervisory scope of the current institutional construction, merely on the basis of pessimism about the political viability of advancing such reforms.

Mindful of the crucial member state politics of building a winning coalition for such an initiative, we note this feature as a strength. The German central banking establishment would likely applaud such separation not just as being based on long-held principles, but also as being a concrete remedy to what it sees as a gradual and potentially dangerous encroachment on its commitment to price stability, the primary mandate of the ECB. Opting for the “German model” in this manner, might in turn allow the EFSA to be located in France, thus enhancing the chances of the proposal winning the support of the French as well. The EFSA could indeed be conveniently located in or around the current facilities of ESMA in Paris.

To broaden and strengthen the alliance of member states in support of this proposal, we would encourage European policymakers to ensure that appointments for top positions in the EFSA acknowledge the interests of other member state coalitions beyond the French-German axis.

We further suggest that the EFSA be established for eurozone countries with a possible opt-in for non-euro countries. We recognise that it would be optimal if an EFSA comprised all EU member states, but given that such steps of integration have proven difficult in the past, we consider opt-ins to be a more realistic scenario.

We are well aware that establishing yet another financial supervisory body will likely be politically challenging. But if European policymakers are serious about strengthening macroprudential regulation in order to prevent a new build-up of systemic risk in Europe’s financial sector, pursuing institutional reform along one of the five paths set out in this brief will be a sine qua non.

4. CONCLUDING REMARKS: HOW TO DO IT

Establishing a European Financial Supervision Authority (EFSA) that is legally, organisationally and geographically separate from the ECB would correspond to what has traditionally been known as the “German model” for dealing with the dual challenges of financial supervision and monetary policy (Goodhart and Schoenmaker 1995).
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Jakob’s research cuts across the disciplines of economics, politics and philosophy of science. Empirically, he focuses on financial crises and financial regulation, emphasising how and to what extent competing narratives shape subsequent policy responses. Jakob’s publications include Discipline in the Global Economy? International Finance and the End of Liberalism (Routledge, 2009) and Central Banking at a Crossroads (Anthem Press, 2014, co-edited with Goodhart, Gabor and Ertürk).

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