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A brief analysis of the new financial supervisory architecture

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ABSTRACT

The equivocal meaning of the word "crisis" in mandarin has been continuously mentioned in the past two years, since the world in general, and the EU and the US in particular, have faced the toughest financial crisis since the 1930's. In the EU's case, along with this complex challenge came the opportunity to change. Among the several reforms that were made in the financial system of the EU, one of the most important ones was that of its financial supervisory architecture, since it addressed one of the main concerns stated on the report elaborated by Jacques de Laroisière and his team after a request from the European Commission President, Durão Barroso. The question that this paper asks is whether the EU is better prepared for a new financial crisis after reforming its supervisory system. It is argued that, although the changes that were introduced were mild ones, the new supervisory framework that was developed has created a structure that will help the EU and the Member States to deal with upcoming crisis, both at macro- and micro-prudential level. The creation of the European Systemic Risk Board, where the European Central Bank will play an important role, as well as the transformation of the previous level 3 Committees into authorities with some binding powers seem to indicate a change for the best. Nonetheless, the lack of empirical evidence concerning their performance, as well as political pressure and the national supervisors' role can still contribute to put the EU further apart from better addressing supervisory issues in a future opportunity, which also means "in a future crisis".

Keywords: Financial supervision architecture, Financial crisis, European Union, Financial reform

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1. Introduction

The current financial crisis unveiled with significant damages the failures of different financial systems around the world. Having its roots in the US, it quickly spread to the EU, demonstrating that the Union's ability to predict and to handle such a crisis was not as good as it should be. The effects are in fact still being felt today, not only in the financial system, but also at the economic cooperation level. Governments have been forced to bail out banks and insurance companies which have taken advantage of a poorly regulated and supervised financial system to put into practice a set of actions which should have been forbidden.

In order to understand the crisis phenomena, the European Commission President, Durão Barroso, requested Jacques Larosière to elaborate a report on what exactly had failed and what should be done to prevent another crisis. This report had several sections which gave an in-depth perspective of what had failed, providing recommendations for what should be done. It might seem paradoxical to address supervision, which normally is intended to prevent crisis and relate it to better preparation to handle the crisis, meaning that I will be analyzing two different moments, but the fact is that a better supervision will most certainly not prevent a crisis but it will definitely make it much easier to handle.

It is fair to say that the forthcoming analysis is not a technical so much as a political one. The objective of the paper is to understand whether the EU is better prepared for a new financial crisis from a supervisory perspective. Two hypothesis were formulated: first, a positive one, arguing that the new financial supervision architecture is the result of a substantial reform which has given the EU the tools that it lacked in order to be better prepared for a new crisis. The second hypothesis, a negative one, argues that the EU has done mostly cosmetic changes that have not sufficiently improved the current situation.

In order to do that, I will start by making reference to the failures pointed out by the de Larosière report concerning supervision, which will then allow to understand exactly whether the new measures implemented will be able to suppress these failures or if everything will remain as it is. Then, I will look at the

changes made to the new architectural framework and analyze whether these changes have actually improved the EU's capacity to respond to critical situations.

Since this is a quite recent subject, there was no abundant literature, which means that most conclusions and comments are my own, for which I am solely responsible.

2. The Laroisière report

In order to understand what failed and the reasons why the new supervision architectural framework was developed as it was by the EU, it is fundamental to start by analyzing what were the main identified issues. Since the options taken by the European Union for its new financial supervision architecture derive from the recommendations made in the Laroisière report[1], one must understand what factors were behind the said recommendations.

The De Larosière group identified eight[2] main problems within the supervisory system which have contributed to the EU's response (or lack of it). The failures that were identified were divided between macro and micro prudential supervision, since both "are clearly intertwined".[3] The difference between the two is clear: whereas micro prudential supervision is focused on individual institutions and on the protection of the institution's customers, trying in that way to prevent contagion risks, macro prudential supervision looks mainly at the system as a whole. Although obvious, this distinction played a major role not only during the crisis period, but also on the development of the new architectural framework, as I will demonstrate further ahead.

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[1] Madsen, Birgitte Bundgaard and Mogensen, Louise Caroline, *A New European Supervisory Architecture,* Monetary Review, 4th Quarter 2009, p. 97; Garicano, Luis and Lastra, Rosa, *Towards a new architecture for financial stability: Seven principles,* Journal of International Economic Law, n. 13, 2010, p. 12

[2] *The de Laroisière report*, High Level Group on Financial Supervision in the EU, 25 February 2009, available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, pp. 38 to 42.

[3] Ibid, p. 38

The first failure pointed out by the Group was that of lack of adequate macro-prudential supervision.[4] According to the Groups conclusions, the previous EU supervisory framework placed too much emphasis on micro-supervision, not relying so much on macro-supervision. With the advent of globalization in the banking area, for instance, failing to see the forest for the trees makes it complex to spot the fires. This was the case, for instance, with the US and Lehman Brothers, whose roots had spread out through banking institutions worldwide and was therefore a banking phenomena. Adding to that, the Group also identified the need to look to other systems rather than the banking one. The Lamfalussy Committees[5], which were part of the system that is now being replaced, already did so, but only on a micro-prudential level.

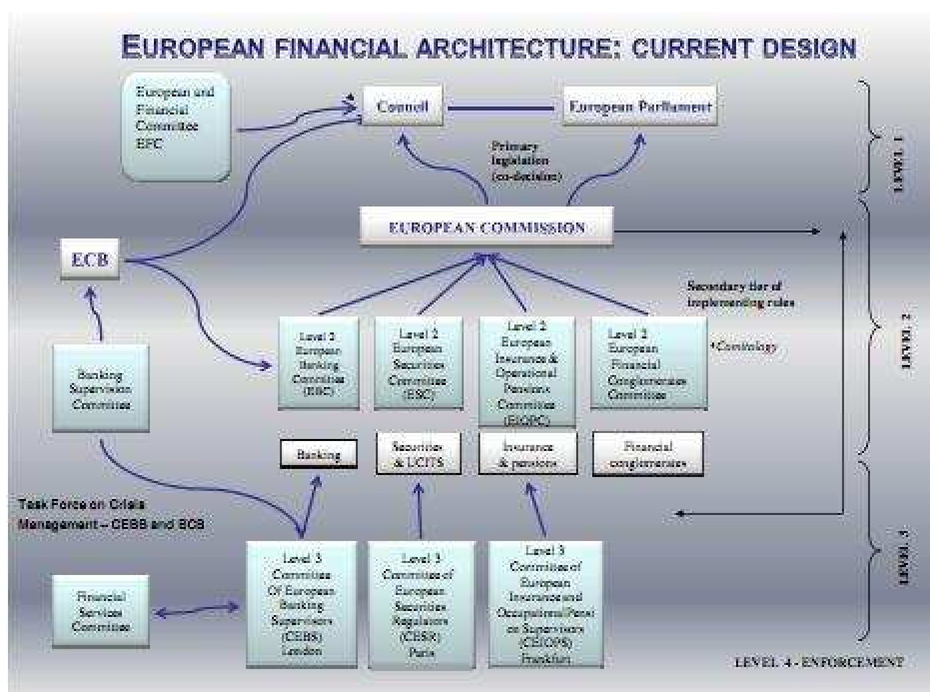

Fig. 1 – Current / Previous European Financial Architecture[6]

But even if the macro-prudential risks had been assessed, it would have been difficult for the EU to put into practice a plan to tackle the crisis, since there was

[4] Ibid. p. 39
[5] Cf. Fig 1
[6] Lastra and Garicano, op. cit., p. 14

no mechanism capable of ensuring that the risk assessment was translated into action, since the early warning mechanisms were, according to the Group report, ineffective.[7] This situation, as I will demonstrate in the following section, has changed in the new architectural framework.

Competence issues were another of the failures identified by the Group, along with failures to challenge supervisory practices on a cross-border basis and lack of frankness and cooperation between supervisors. On the first case, the problem was mainly a failure of supervision by national supervisors. One of the examples given is the supervision of Northern Rock, a British bank, by the UK Financial Services Authority (FSA). The bank had to be nationalized and the FSA chief executive, Hector Sants, admitted that "*it was clear that our supervision of Northern Rock in the period leading up to the market instability of late last summer was not carried out to a standard that is acceptable*".[8] Concerning the second, the problem is that of institutions that are spreading their activities towards other countries while maintaining their headquarters on the base country. If the supervisory authorities on the first country are unable to fully regulate and predict issues on the main branch, this can have problems on other branches, which might ultimately generate problems on the countries where they are established. Ultimately, this can lead to restrictions to firms expansion perspectives, thus limiting the internal market.[9]

Moreover, the lack of frankness and cooperation between supervisors meant basically that there was an "*erosion of mutual confidence among supervisors*"[10]. Although this might seem again an obvious statement, trust and cooperation between supervisors, both at national and at EU level is essential to make both systems (the current and the future one) work, since they are based on the exchange of information between institutions and committees ("authorities" in the new architectural framework).

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[7] The de Laroisière report, p. 40
[8] *Watchdog admits failure over Rock,* 26th March 2008, BBC, available at http://news.bbc.co.uk/2/hi/business/7313896.stm
[9] The de Laroisière report, p. 41
[10] Ibid.

The following and final three failures pointed out by the Group are concerned with the lack of consistent supervisory powers across Member States, the lack of resources in level 3 Committees and finally the lack of means for common decision-taking.

Regarding the first one, the problem is one of standard harmonization. Each Member State has its own supervisory system, as well as its own way of enforcing it. This leads to different supervising and enforcement actions, which leads to a tough task concerning supervision on a cross-border level.

Adding to that, the lack of resources on level 3 committees compromised their capacity to react, as well their reaction speed. As mentioned by the Group, this prevented them from performing "*either by way of peer review or by way of identifying sector wide risk issues*".[11] These Committees, which were transformed in Authorities in the new framework, played a significant role in the now changing architecture, since their task was to facilitate the convergence of regulatory and supervisory outcomes and best practices, mainly through the establishment of non-binding guidance.[12] Their incapacity to react, as said above, compromised their functions. Nonetheless, it is important to point out that the guidance and convergence provided by these committees was non-binding, which might have made more difficult any attempt for convergence. In fact, the lack of means for decision-taking is pointed out as the final failure by the Group, since they did not have "*the legal powers to take decisions*[13]".

Naturally, and this is pointed out as well on the Group report, the crisis was not solely the responsibility of the EU's supervisory system. Nonetheless, the EU supervisory system failed as well, showing that, on supervision matters, the EU was not fully ready to cope with a systemic crisis, as I have shown on this section. The crucial question, which will be approached in the next sections, is to know whether the European Union is now better prepared to deal with a financial crisis.

[11] Ibid

[12] Financial Services Agency, *Lamfalussy,* available at http://www.fsa.gov.uk/pages/About/What/International/european/lamfalussy/index.shtml

[13] The de Laroisière report, p. 41

3. The new architectural framework

Following the presentation of the Group's report, actions were taken in order to implement some of the recommendations that were made. Accordingly, on September 2009, the Commission presented a proposal for a new supervisory architecture and, on September 2010, the European Parliament gave its final approval for the financial supervision package.[14]

What does the new system entail is the subject of my analysis in this section. Therefore, I will look at the new structure, in order to understand exactly what has changed and how will the new supervisory system work.

To begin, it should be underlined that the EU's supervision architecture is characterized by three principles, which were already part of the Lamfalussy structure: decentralization, co-operation and segmentation. As stated by Garicano and Lastra, "*prudential supervision remains decentralized at the level of Member States, based upon the principle of home country control, combined with mutual recognition on the basis of prior harmonization*".[15] What this means in essence is that Member States retain the prudential supervision control while making use of the mutual recognition principle to acknowledge other Member States decisions and actions.

Adding to that, the new architecture is divided in two main parts: one that addresses macro-supervision and one that looks at micro-supervision. This is actually a step ahead, based on the recommendations made by the Group. As I have mentioned before, one of the identified failures was the lack of a macro-prudential supervision entity. That problem was solved by creating a new entity in the new architectural framework: the European Systemic Risk Board (ESRB). This entity will be responsible for rapidly assessing and preventing potential risks

[14] *Financial Regulation: the EU's agenda*, Euractiv, 12 October 2010, available at http://www.euractiv.com/en/financial-services/financial-regulation-eus-agenda-linksdossier-188497

[15] Lastra and Garicano, op.cit., pp. 12-13

and threats at a macro-economic level to the EU's financial stability, mainly through the issuing of recommendations and warnings.[16]

3.1. The European Systemic Risk Board (ESRB)

On the following image, it is possible to understand the level at which the ESRB is placed, its functions as well as the way how it is organized.

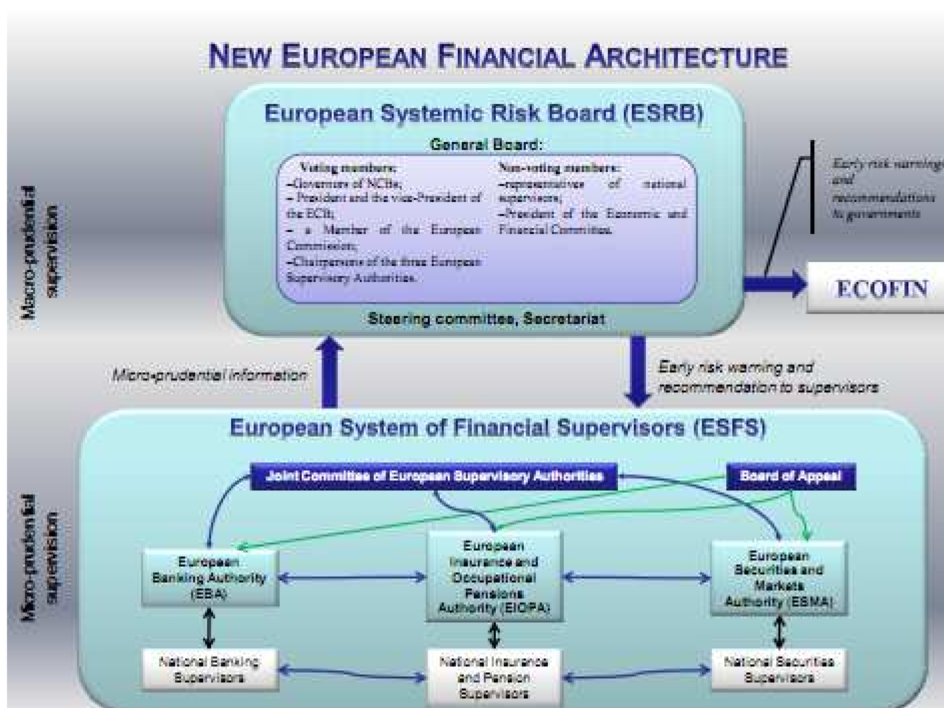

Fig. 2 – New Financial Architecture Scheme[17]

The creation of this new entity suppresses two requirements mentioned on the Group's report: first of all, it allows for a macro-prudential supervision to take place. Secondly, it puts into practice a theoretically effective early risk warning system, since, in this case, it will be issued by a specific entity with determined

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[16] European Commission, *New Financial Supervision Architecture: Q&A on the European Systemic Risk Board,* MEMO/09/405

[17] Lastra and Cagliaro, op.cit., p. 16

competences, whose task is exactly to gather and analyse relevant information concerning those risks.

Warnings and recommendations may be issued both at EU and national level, as well as to the Supervisory Authorities. The ERSB will then elaborate a color-coded system, corresponding to situations of different risk levels.[18] In order to ensure that the recommendations of the ESRB are followed, it is predicted a follow up[19], based on a "act or explain" approach, which means, in essence, that the Member State or entity to which the recommendations were addressed will have to either implement the recommendation or explain why it hasn't done so. In case the addressed parts fail to explain the reason why they have opted for a non-implementation of the recommendation, the ERSB will have the power to communicate this to the European Council and to the concerned European Supervisory Authorities, when relevant. [20]

Another very important aspect of the ESRB is the close relation with the European Central Bank (ECB). In fact, when analyzing the ESRB structure, the importance of the ECB is clear, especially when looking at the General Board, which comprises the President and Vice-President of the ECB (with the President chairing for the first five years), as well as the Governors of the national central banks, among other Members with voting rights. This can be seen, as it was, as a first step towards the "twin peaks" model of supervision, where there is a single authority for banking and insurance supervision, operating under the auspices of the ECB and another authority for securities and consumer protection[21], with the ECB in charge of macro-prudential supervision and co-supervision of the large cross-border financial institutions. Although it is not the task of this paper to analyse the role of Central banks on the EU's financial supervision system, it is important to stress that the strong presence of the ECB on a macro-economic

[18] Council of the European Union, doc. 12815/2/10 REV 2, 14 September 2010, art. 16/4
[19] Ibid, art. 17
[20] Ibid, art. 17/2
[21] *First steps towards twin peaks model of financial supervision*, Euractiv, 28 July 2010, available at http://www.euractiv.com/en/financial-services/first-step-towards-twin-peaks-model-financial-supervision-analysis-496770

supervision level can certainly be read as a sign that the architectural reform of the EU's financial supervision system is just starting.

The question that comes up after analyzing the structural elements of the ESRB is whether it works. Theoretically and technically, the answer seems to be positive. Nonetheless, it is yet to be seen how it might handle political pressures, since it issues mainly recommendations and warnings. The fact that it is chaired by the President of the ECB, with all the central bank governors involved does not necessarily mean that it will be able to wave off pressures, since it has different tasks than those of the ECB and it has as well, on its General Board, many other representatives with voting rights. Adding to that, there is the compliance aspect, which was already mentioned before when I made reference to the recommendations and warnings. In fact, the ESRB has the power to inform the Council about any non-compliance. More important is its capacity to make the recommendations public. The problem is that it entails a risk: either the ERSB puts pressure into Member States or national supervisory authorities by going public, thus creating, with a bigger or a smaller degree of certainty (depending on the case), a possible negative reaction; or it can simply expect for the Council to react within the premises of confidentiality, which, due to the intergovernmental nature of the Council, is not an assurance. If the national supervisor belongs to one of the big Member States or even if the addressee is the big Member State itself, it is yet to be seen what will be the Council's reaction.

Is the EU, then, more prepared, at a macro-economic level for a new crisis? Theoretically, yes. The reforms that were implemented and that will start working in the beginning of 2011 were more than cosmetic changes. The fact that the EU is now able to see the forest for the trees seems to back up my first hypothesis, that the EU has been able to develop a strong - macro-prudential - supervision system. On the next section, I will analyse whether the new micro-prudential supervision system achieved the same success.

3.2. The European System of Financial Supervisors (ESFS)

The micro-prudential supervision system suffered significant changes, starting with the creation of three authorities which have replaced the previously existing Level 3 Committees. Adding to that, it was also created a Joint Supervisory Committee, as well as a board of appeal. These different bodies, in connection with national supervisory institutions, form the European System of Financial Supervisors (ESFS). A key body which is not included on fig. 2, since it already existed before, are the Colleges of Supervisors. The Colleges had already been created under the Capital Requirements Directive (2006/48/EC) and have seen their competences been subject to an enhancement proposal by the Commission.[22] Their functioning, efficiency and effectiveness will be monitored and promoted by the new authorities.[23]

To begin with, it is essential to stress that the ESFS will be a network of supervisors at national level that will be working directly with three European Supervisory Authorities in three different areas: Banking (EBA), Insurance and Occupational Pensions (EIOPA) and Securities (ESMA), replacing the three existing committees of supervisors at EU level[24]. Direct supervision of financial institutions will remain a competence of national supervisory authorities[25], whereas the three European Supervisory authorities will have the power to investigate alleged breaches of EU law, to draft binding technical standards and adopt non-binding ones (with the objective of preparing a single EU rule book), to mediate disputes between national authorities, to undertake coordination and

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[22] European Commission, *Commission proposes revision of bank capital requirements rules to reinforce financial stability*, MEMO/08/599

[23] Council of the European Union, doc 13070/3/10 REV 3, 14 September 2010, art. 12

[24] Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR).

[25] Madsen and Mogesen, op.cit, p. 101

decision-making in crisis situations, as well as collecting relevant information about the financial markets.[26]

Concerning their relation with Colleges of Supervisors, which are "*permanent structures for cooperation and coordination amongst authorities involved in the supervision of cross-border financial groups*"[27], the new ESAs will contribute to ensure consistent implementation of Community law. It can be argued that the importance of this measure is the fact that it strengthens the EU's capacity to better supervise cross-border financial groups, because it gathers the capacities of both sets of bodies (the Colleges of Supervisors, handling cross-border financial groups and the ESAs, safeguarding the stability of the financial system) and in theory solves one of the failures pointed out by the Group. In practice, this means that the authorities will complement the Colleges by ensuring that supervisory standards in the EU are of the highest quality for all institutions, facilitating the College's tasks through their role in information distribution and providing a mechanism that will ensure the consistency of the Colleges for each cross-border group.[28]

The question that arises is, naturally, whether the new measures have made the EU more ready for a financial crisis from the micro-prudencial supervision perspective. Going back to the formulated hypothesis, it is clear that the transformation of the previous Lamfallussy level 3 advisory committees in "*watchdogs with a bite*[29]" is very important for the enhancement of EU's supervision capacity. The new Authorities will be able to look into completely different subjects and their capacity to influence standardization at EU level is clearly a step ahead, as well as the power to ensure consistent application of EU supervision and to act in emergency situations, among the others that were already

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[26] Ibid, p. 104; Council of the European Union, *Financial Supervision: Council adopts three legal texts establishing the European Systemic Risk Board and three new supervisory authorities*, doc. 16452/10, 17 November 2010

[27] Ibid.; Committee of European Banking Supervisors, *Colleges of Supervisors – 10 Common Principles*, CEBS 2008 124, 27 January 2009

[28] European Commission, *European System of Financial Supervisors (ESFS): Frequently Asked Questions*, MEMO/09/404, 23 September 2009

[29] *Parliament gives green light to new financial supervision architecture,* EP Newsletter, 20-23 September, p. 18

mentioned before. Therefore, it can be said that there has been a "*subtle shift in power*"[30] from the Member States to the EU. But why subtle? As Philip Whyte puts it, "the new edifice is a compromise".[31] First of all, the ESAs will not be the ones supervising financial institutions, the national authorities will. This can actually create a problem, since national authorities will be supervised, but not commanded. Therefore, they are not completely safe from danger and there is a chance, even if a smaller one, that mistakes are made. Then the ESAs powers have also to be taken *cum grano salis*. Concerning binding decisions, they will only be able to take them in exceptional circumstances. Otherwise, they'll only be able to draft them, which is not an approval seal. Plus, even in case of an "emergency situation", there is a fiscal safeguard for Member States, i.e. they cannot be forced to bail out a bank. Finally, creating a non-binding set of standards will definitely take a significant amount of time, which can be an issue for standard harmonization and, therefore, to a better supervision procedure.

Finally, another issue the ESAs might face will be that of political pressures. These were already mentioned on the first part concerning macro-prudential supervision. The fact is that the ESAs are composed by the heads of the 27 national supervisory authorities, which will certainly take into account their own perspective in the ESAs meetings. As Philip Whyte puts it, the ESAs have to avoid becoming "*arenas for skirmishes between member-states*"[32]. Moreover, the role played by the ESAs will eventually determine their evolution in the architecture. So far, their task will be mainly to supervise the supervisors, as the supervisory control remains mostly with national authorities. Even in this case, the ESAs powers are limited. Therefore, time and practice will tell what will the ESAs become, as well as whether they will succeed. Nonetheless, it seems that the efforts developed have made the EU, from a micro-prudential perspective, abler to actually prevent and deal with a new financial crisis.

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[30] Whyte, Philip, *The EU's new supervisory architecture – evolution or revolution?*, CER bulletin, issue 74, October / November 2010
[31] Whyte, Philip, op.cit.
[32] Ibid.

4. Conclusion

The objective of this article was foremost to understand whether the EU, after the changes introduced by the new financial package, especially in the financial supervision area, would be prepared to better deal with a new financial crisis. It might seem a paradox, as it was mentioned before, to ask whether the EU is better prepared to deal with a crisis and then analyse the system which aims at preventing it. The truth is, the nature of financial crisis might make them quite difficult to prevent, but a good supervision system will certainly be able to narrow down its effects. For this purpose, two hypothesis were put on the table: the first one argued that that the EU is better prepared because the changes that were introduced to its supervisory architecture and because it has been able to implement and develop a set of instruments that will not only facilitate its task, but also give the EU a wider perspective of the problem (i.e. ESRB). The second one stressed the idea of a cosmetic change, which had maintained the structure's essential aspects, making only circumstantial changes.

In order to test both these hypothesis, I started by making reference to the structural failures that were identified by the de Larosière group, which was formed to, in simple terms, analyse what went wrong. The Group identified eight main failures and proposed recommendations to tackle them. Most of them were taken into account by the Institutions in the creation of the new architecture. That was demonstrated basically by the creation of the European Systemic Risk Board, responsible for macro-prudential supervision and by the European System of Financial Supervisors, which will be responsible for micro-prudential supervision. Whereas the first one was created from scratch, the second one evolved in part from the Lamfallussy process, namely the Advisory Committees which gave way to the current European Supervisory Authorities. These develop the same tasks, adding to those a set of powers and competences that, if used properly, will allow for better coordination and supervision of national supervisors. In essence, it will mean a more harmonized approach than before, which, taking into account the global aspects of the crisis, can only mean a more positive result. Nonetheless, it

is yet to be seen what will the results of political pressures be and how will the ESAs handle them. As for the ESRB, I have pointed out the importance of having a macro-prudential perspective that would be able to gather information at a higher level and prevent systemic risks. The question is: will it be able, especially concerning the recommendations, to make its will prevail or will the Council play a significant role in the end.

The questions that are and will keep on being made stem from the lack of activity of the new bodies that were created. Nonetheless, as was already stated, in theory it seems that the EU and its new architecture will be able to better supervise and handle a new financial crisis. The changes that were introduced were clearly not cosmetic, filling in the gaps pointed out by the Group. Therefore, my first hypothesis has been confirmed.

Naturally, there are opinions that, due to the extent and nature of this article, could not be approached here, but are both interesting and pertinent. The single supervisory authority is one of them. In fact, the idea that one central agency or supervisory body would be the adequate answer for the crisis can sometimes be found in the literature.[33] Looking at the picture from this perspective could provide an interesting insight on the pros and cons of such a solution, as well as confirm or dismiss the arguments that stand for this solution.

It is also important to mention that, even if the supervisory framework is already set, the reform of the whole system is far from being finished, not only in the supervision area, but also in the regulation one. In practice, this means that the legislative proposals that will be put forward by the Commission might still influence, even if indirectly, the supervisory practice in the European Union. A good example is the Crisis Management in the Banking Sector Proposal, which has been the subject of a Commission communication that will be followed by a legislative proposal in Spring 2011.[34]

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[33] Cf, for instance, Lastra, Rosa M., *The Governance Structure for Financial Regulation and Supervision in Europe,* The London Financial Regulation Seminar, London School of Economics and Political Science, 19 May 2003

[34] European Commission Communication, *Regulating Financial Services for Sustainable Growth,* COM 301 final, 02 June 2010