The proposals of the de Larosiere Group on the future of financial supervision in the European Community

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I. The existing framework for the exercise of supervision in the European financial system and the need to re-adjust it

A. Some basic assumptions

1. The view that the current financial system functions without the existence of a regulatory or supervisory framework – or that it is self-supervised – does not correspond to the reality
2. The neoclassical model on which the modern financial system is based incorporates the possibility of market failures, in particular:
    - the existence of information asymmetry, and
    - the occurrence of negative externalities

   The objective of regulatory intervention is to address them
3. The process of "de-regulation" was about the abolishment of restrictive measures in the operation of financial systems, mainly connected with state intervention for the allocation of borrowed funds

A. Some basic assumptions

4. In all market-based economies the existing regulatory framework for the financial system consists of rules that seek to ensure the following policy goals:
   - Ensuring the stability of the financial system, its sectors and infrastructures (banking sector – capital markets – insurance sector – payment and settlement systems)
   - Ensuring the effectiveness of capital markets and investor protection
   - Ensuring the effectiveness of payment systems
   - Ensuring the protection of consumers of financial services
   - Combating the commitment of crime within the financial system
5. Offshore financial centers constitute the exemption allowing for regulatory arbitrage

B. The existing European architecture of the monetary and financial system

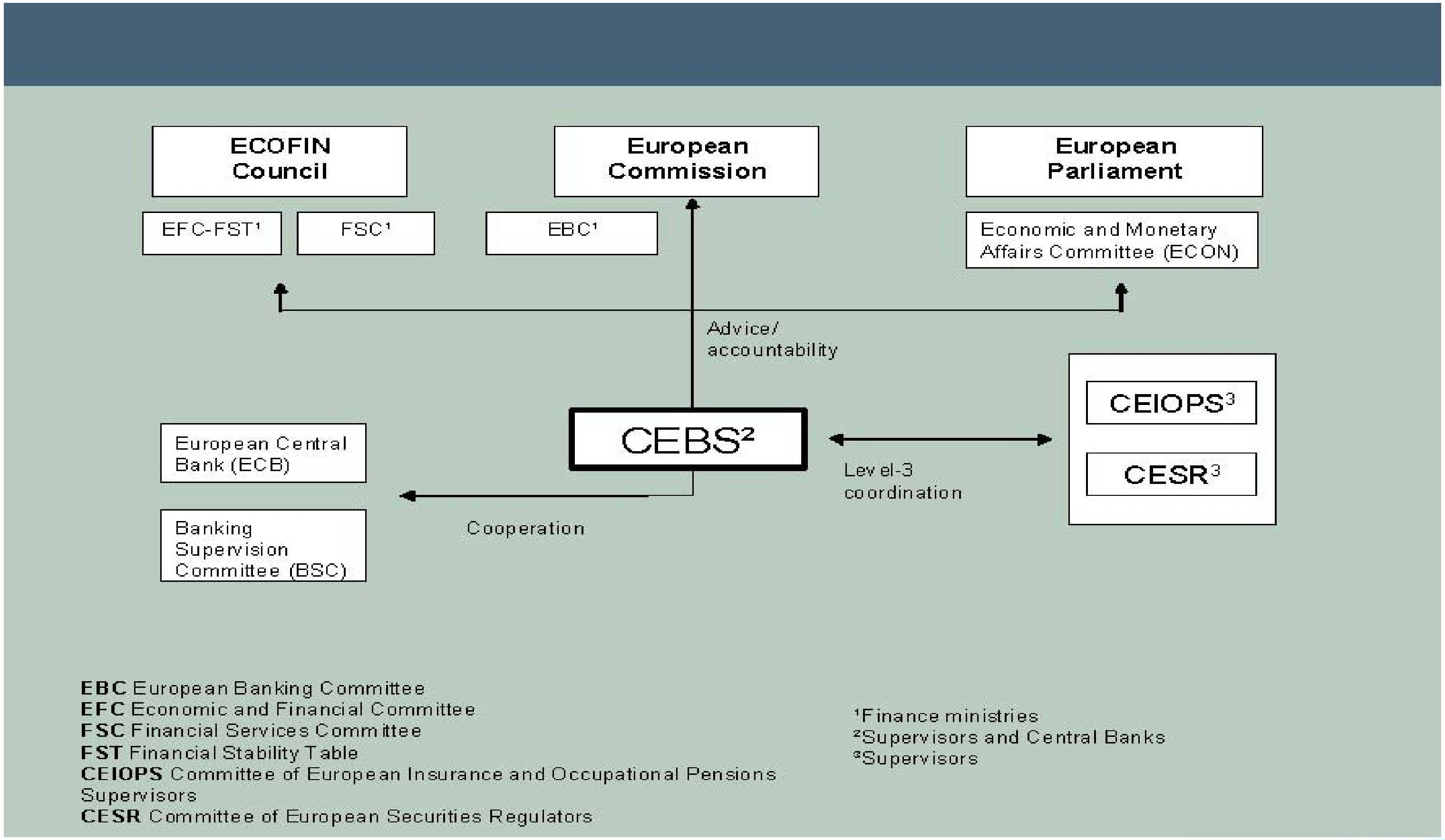
1. European monetary system: regional monetary union – single monetary policy *cum* single currency

2. European financial system – architecture in the course of financial integration

2.1 Institutional framework: three categories of legal acts in the law-adoption process (Lamfalussy process) (see Table 1)

- basic legal acts (Co-decision procedure: European Parliament – Council (EcoFin))
- implementing measures (European Commission with the assistance of "regulatory committees" and "pan-european networks with the participation of sectoral supervisory authorities" (CEBS – CESR – CEIOPS), see below the diagram)
- Soft law rules: CEBS – CESR – CEIOPS

The European financial regulatory/supervisory structure



B. The existing European architecture of the monetary and financial system

2. European financial system (cont.)

2.2 Supervisory framework

- absence of supranational, pan-European supervisory authorities even after the establishment of the EMU (Treaty, article 105, para. 5)
- each member state is free to determine the institutional structure of its domestic financial supervisory framework
- EU rules on the division of responsibilities between national competent authorities with regard to foreign branches
- EU rules on the consolidated supervision of foreign subsidiaries
- EU rules on consolidated supervision of “financial conglomerates” (solo plus)
- EU rules on cooperation between national competent authorities

B. The existing European architecture of the monetary and financial system

2. European financial system (cont.)

2.3 Regulatory framework:

2.3.1 Structured system of rules of (mainly hard but also soft) European financial law with respect to all the above-mentioned (page 4) policy goals of regulatory intervention within the process of financial integration

2.3.2 Significant influence by international financial standards, mainly those produced by:

- the Basel Committee,
- the FATF, and
- the IASB

C. Towards a new supervisory framework

1. **The option of creating a supranational, pan-European financial supervisory system**

The main argument in favor of such a structure, which has been discussed heavily especially after the establishment of the EMU

It represents one of the options to effectively supervise and regulate pan-European, "systemically important" financial conglomerates, due to the threats they are posing to the stability of the European financial system

C. Towards a new supervisory framework

1. **The option of creating a supranational, pan-European financial supervisory system (cont.)**

Two main alternatives (taking as a starting point the current structure of European financial law):

- establish a “European System of Financial Supervisors” (see below under 2), or
- activate para. 6 of article 105 of the Treaty, according to which the ECB could become, even though under constraints, a European financial supervisory authority (see below under 3).

C. Towards a new supervisory framework

1. The option of creating a supranational, pan-European financial supervisory system (cont.)

In principle, in either case the following eight (8) issues need to be addressed:

- the necessary extent of amendments of the Treaty,
- the institutional structure of the system,
- the material coverage of its supervisory powers in the financial system (banking sector – capital markets sector – insurance sector),
- the personal coverage of its powers (which categories of financial firms and groups would be subject to supervision and by whom),

C. Towards a new supervisory framework

1. **The option of creating a single supranational, European financial supervisory system (cont.)**

- the extent of its regulatory powers,
- its decision-making bodies, their composition and their competences,
- the independence of its constituents, the decision-making bodies and the persons appointed therein, and
- its overall embedment within the existing institutional structure of the European Union/Community.

C. Towards a new supervisory framework

2. The establishment of a "European System of Financial Supervisors" – outside the European Central Bank

General assessment:

- a legally demanding and time consuming option,
- but still a more straightforward solution for the effective supervision of European financial conglomerates (under current Treaty provisions – article 105.6)

C. Towards a new supervisory framework

2. The establishment of a "European System of Financial Supervisors" – outside the European Central Bank (cont.)

Three options:

- three authorities ("sectoral approach") based on the existing three so-called "Level 3 Committees" (i.e., CEBS, CESR and CEIOPS) established by the Commission
- two authorities ("twin peaks approach")
- one authority ("consolidation approach")

C. Towards a new supervisory framework

3. Assigning the task of financial supervision to the ECB:

General assessment:

- it renders the exercise simpler with respect to the majority of the abovementioned questions, since its powers in the field of financial supervision would be embedded within the existing structure and institutional setting of the ESCB.
- the relevant decision by the EcoFin Council could be taken within a definitively shorter time horizon than if the decision would be taken to create a European System of Financial Supervisors.

C. Towards a new supervisory framework

3. Assigning the task of financial supervision to the ECB (cont.)

- upon activation of art. 105, para. 6 of the Treaty (which requires *a unanimous decision by the EcoFin Council)*, the ECB could only become a "sectoral supervisory authority", since *insurance undertakings are explicitly excluded*,
- a decision should be taken in this case as well with regard to the range of financial firms and groups which would be subject to the supervision of the ECB and those who should continue to be supervised by the national competent authorities.
- need to consider the approach according to which conflicts arise if a monetary authority is also, concurrently, a financial supervisor
- need to reconcile the supervisory powers of the ECB with those of the national supervisory authorities, especially in the case of the member states (which are now the majority within the EU) which have adopted the "integrated approach".

C. Towards a new supervisory framework

D. The impact of the current crisis

1. New discussions on the need to establish pan-european supervisory authorities for the financial system
2. Supervision has two dimensions:
   - macro-prudential (the one mostly neglected)
   - micro-prudential
3. The European Commission assigns the task of submitting proposals to the "de Larosière Group"

II. The two proposals of the “de Larosière Report” on re-adjusting the existing framework for the exercise of supervision in the European financial system:

an overall examination

Table 2:
THE DE LAROSIERE PROPOSALS (1)

I. The short term proposal

Two (2) components:

A. Strengthening of the quality of supervision exercised at European level – Creation of a "European system of supervision and crisis management”

B. Strengthening of the quality of supervision exercised by national supervisory authorities

Table 2:
THE DE LAROSIERE PROPOSALS (2)

A. Strengthening of the quality of supervision exercised at European level – Creation of a "European system of supervision and crisis management"

Two (2) parts:

1. **European system of supervision**
2. European system of crisis management: Strengthening the regulatory framework governing the reorganisation and winding-up of credit institutions

Table 2:
THE DE LAROSIERE PROPOSALS (3)

1. **European system of supervision**

Establishment of two (2) European bodies:

(a) The European Systemic Risk Council: a body for "macro-prudential supervision" *(immediately)*

(**b**) European System of Financial Supervision a body for the "micro-prudential supervision" based on the operation of three European Authorities *(in two stages)*

- European Banking Authority
- European Securities Authority
- European Insurance Authority

Table 2:
THE DE LAROSIERE PROPOSALS (4)

II. The long term proposal:

Establishment of two (2) European Authorities for micro-prudential supervision

- one Authority responsible for banking and insurance prudential supervision issues, as well as any other issue which is relevant for financial stability
- one Authority responsible for conduct of business and market issues, horizontally across the entire financial system

III. The two stages for establishing the European System of Financial Supervision (ESFS)

III. The two stages

1 Introductory Remarks

2. Initiatives on strengthening supervision at national level

3. Initiatives regarding the strengthening of level 3 Committees

    3.1 Strengthening the budget

    3.2 Full development of the “peer review process”

    3.3 Strengthening the duties

    3.4 Establishing the principle of qualified majority and further strengthening of cooperation

4. Initiatives in relation to the other components for ensuring stability of the financial system

    4.1 Strengthening the degree of harmonization of rules according to which regulatory intervention is exercised in the financial system

    4.2 Strengthening risk management mechanisms

IV. The two European “bodies” proposed to be established

The two European bodies

A. The European Systemic Risk Council (ESRC)

1. Composition – Governance (Table 3)

2. Tasks

2.1 Allocation of tasks and the conditions for their effective performance

2.2 Ensuring a proper flow of information between the ESRC and national supervisors

2.3 Macro-prudential warning mechanisms

2.3.1 Actions taken when risks are detected

2.3.2 Actions taken when serious risks are detected

Table of Contents (cont.)

V. Post-script: current EU developments in the field of financial regulation and the rescue - recovery programmes

A. Current EU developments in the field of financial regulation

A. The main regulatory measures which have already been undertaken or are under preparation relate to the following issues:

1. Enhancement of the capital requirements framework
2. Enhancement of liquidity risk management
3. Review of deposit guarantee schemes
4. Ensuring adequate valuation of financial instruments
5. Review of the regulatory framework of Credit Rating Agencies
6. Enhancement of transparency in financial markets and securitization process

B. The rescue - recovery programmes

1. Differences in scope

2. The **main issues dealt with** in the rescue and recovery programmes:
   - the avoidance of undue distortions of competition, and
   - the avoidance of moral hazard

3. The main **points of criticism** to these programmes:

- taxpayers are “footing the bill”,
- slow implementation of the support measures,
- the ongoing “credit squeeze”.