

Financial Supervision in Europe: Commentary on the Communication of the European Commission

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The Commission has requested comments to their Communication on "European Financial Supervision" (COM (2009) 252 final) dated May 27th 2009 (1).

Introduction

In the "impact assessment", document which forms an integral part of the Communication, the Commission makes a strong case for recommending an approach that is largely inspired by the de Larosière Report. Having discarded the alternatives of a "Dynamic status quo", the "Host country model" and the "Lead supervisor model" as inadequate, the discussion centres around two proposals: the "de Larosière Report" and a "Single EU level supervisor".

The Commission endorses the pragmatic assessment of the de Larosière Report which, in order to achieve a broad consensus, recommends a progressive approach, subordinating the long term goal of a "Single EU Supervisor" model, to further progress in EU integration. The Commission recommends, however, considerable speeding up of the timetable aiming at implementing reforms by 2010.

Many commentators, including the undersigned, believe that the Single EU Supervisor model will "ultimately" impose itself. It is therefore suggested that, in parallel with the implementation of the reform outlined in the Communication through the adoption of an appropriate Directive applicable to the 27 Member States, consideration be given by the 16 participants in "European Monetary Union" to enter into a "reinforced cooperation agreement" which would establish a "Single Eurozone Supervisor" that would be fully compatible and integrated within the broader EU wide framework.

By accepting voluntarily to move immediately to a system of a "Single Eurozone Supervisor", it would be possible to address with greater flexibility some of the problems discussed in more detail hereunder. At the same time, the ground would be laid for a long term smooth transition to a "Single EU Supervisor" model as new Member States join EMU (as they must under the terms of the Treaty if they do not benefit from a derogation).

In the following section we highlight some of the areas which, in our opinion, deserve further reflection. They pertain successively to the ESRC and the ESFS and contain proposals relating to the questions of the organisation of the "supervisory profession" as well as of "competencies", both of which appear to have been overlooked.

The European Systemic Risk Council ("ESRC")

The new supervisory framework assigns to Central Banks a major role in addition to their current responsibilities. While recognizing their unquestioned competence and their institutional role and responsibility concerning monetary and financial stability, their dominance of the ESRC raises a number of questions.

A first potential "weakness" resulting from the composition of the ESRC is that all its Members are "ex-officio", i.e. they are appointed on the basis of criteria that are not necessarily directly related to the specific role they need to play as Members of the ESRC. Consequently, it disallows the possibility of appointing Members to the ESRC whose personal experience, in either the private or public sector, could be of great relevance as well as providing a welcome diversification to the perceived "corporatist" mindset of Central Bankers.

Consideration should be given to modifying the composition of the ESRC so that it can benefit from competencies found outside of the existing monetary/regulatory institutional establishment to achieve a better balance in points of view represented. Should conferring "full" membership to "outsiders" prove unrealistic, the ESRC should at least be flanked by an "independent" high level Advisory Board in addition to the "technical advisory support Committee" referred to in p.7 of the Communication. This would provide a useful counterweight to the overwhelming influence of Central Banks as well as broaden the scope of the skills and experience available to conduct macro-prudential surveillance.

A second question concerns the potential for conflicts of interests developing within Central Banks. This results from the lack of uniformity of the existing regulatory architecture among Member States. Indeed, in some countries Central Banks perform the role of "supervisory authority" for the banking sector. In such cases it could prove difficult to reconcile the dual role of formulating recommendations with the obligation of implementing the findings.

Another aspect of possible conflicts of interest concerns the position of Central Banks that are Members of the Eurozone: on the one hand they are expected to exercise their "sovereign rights" on an equal footing with non Member State Central Banks as described in the Communication, while, on the other, they are bound by their Membership of the European System of Central Banks. This is of particular relevance in the areas of determining "monetary policy", acting as "lender of last resort" or in playing a central role in "crisis management" (2), where it would seem unlikely that the ESRC Members could vote recommendations on matters or measures addressed to the Eurozone or its Members which would not have already fully been taken into account by the ECB itself.

This raises another difficulty: as presently envisaged (one man one vote/simple majority), the voting power of the 16 Central Banks Member of the Eurozone plus the vote of the Chairperson and Vice-President of the ECB gives at all times an implicit "permanent" majority (18/33) to representatives of the EMU. The proposed system provides EMU Members with the opportunity to "vote" recommendations affecting monetary policy of non Eurozone Members forcing them to "comply or explain". This creates an "imbedded" bias that will be more than likely prove difficult to accept by the non EMU Member minority.

Another aspect concerning voting power relates to the "1 + 1" formula for each "national" delegation. While it aims at efficiency, it also reinforces unduly the weight of Central Banks in the ESRC.

A further area which might raise opposition, particularly on behalf of non EMU Members, is the proposal that the ECB perform the function of aggregating information collected by the three Supervisory Authorities forming the EFSF, for transmission to the ESRC. We suggest that, while the ECB is ideally suited to perform the function of Secretariat (including logistical support) to the ESRC, the specific task of aggregating the data collected by the ESFS Authorities from their National Members for transmission to the ESRC be assigned to a specially created "Directorate" of EUROSTAT, protected by adequate firewalls to ensure confidentiality.

Finally, the accountability of the ESRC is limited to "reporting" to the European Council, Parliament and Commission, leaving little room for any "constructive" oversight. This derives from the mandate together with the absence of legally binding powers.

Indeed, the proposals put the onus on the recipients of "recommendations" to act accordingly. It follows that it will be necessary to imbed in the legislation a clear trail of "responsibilities" for implementing ESRC recommendations: in addition to the reporting "obligation" to the ESRC by addressees of recommendations, appropriate powers should be conferred to the Commission to enforce these obligations and, if needed, accompanied by sanctions. The Commission or ECOFIN could, for instance, suspend uncooperative Member States from participation in ESRC deliberations. Failure to provide such safeguards would seriously compromise the credibility and efficiency of the ESRC.

The European System of Financial Supervisors ("ESFS")

> Structure

It is suggested that "overarching ESFS Steering Committee" be given a "formal status" on par with the ESRC. This is highly desirable in order to confer on the ESFS the formal authority needed to exercise its responsibilities, in particular in the following areas:

- to ensure appropriate and effective coordination between the ESFS and the ESRC as more fully described in the Communication (p 14);
- to coordinate activities involving more than one Authority such as: coordination of responses between Authorities in case of crisis; resolution of disputes between Authorities; coordination of supervision of conglomerates; ensuring progressive convergence of "supervisory approaches"; Ensuring coordinated representation internationally; exercising supervision of specific entities (CRAs, etc.).

The ESFS, as a formal body, would only intervene in areas where the competence of more than one Authority is concerned. Rather than build an independent "operational" capacity, it should draw on the resources of its three constituting Authorities on an ad hoc basis to exercise its responsibilities with the logistical support of a Secretariat.

The ESRC should have observer status on the ESFS Steering Committee.

> Independence

The Communication emphasises the need for the Authorities to have the "highest degree of independence" from their "national authorities". This seems somewhat at variance with another recommendation that suggests that "rules be adopted by qualified majority based on Treaty weighting for Member States".

> Enforcement

The Communication defines the areas in which the ESFS and/or the three Authorities must be conferred the necessary authority to fulfil their mandate. These include:

- Consistent application of EU rules – "The European Supervisory Authorities should have, in cases clearly specified in Community legislation, the means to ensure coherent application of Community legislation."
- Disagreement between national supervisors – "If, after a phase of conciliation, the latter have not been able to reach an agreement, the European Supervisory Authorities should, through a decision, settle the matter."
- Manifest breach of Community Law – "The European Supervisory Authorities, on their own initiative or upon request from one or more national supervisors or from the Commission, would investigate the issue and, if necessary, adopt a recommendation for action addressed to the relevant national supervisor." And "In order to overcome inaction in relation to the implementation of Community law or delaying of action by national supervisors or in case of need for urgent action, the European Supervisory Authorities could also be empowered to adopt decisions directly applicable to financial institutions in relation to requirements stemming from EU Regulations relating to the prudential supervision of financial institutions and markets as well as the stability of the financial system."
- Coordinated response in crisis situations – "In specific crisis situations, the European Supervisory Authorities could have the power to adopt some emergency decisions (e.g. on short-selling) - the scope of these emergency procedures should be defined in Community legislation."
- Safeguards – "The framework for the exercise of the above competences will be specified exhaustively and in precise detail in the relevant sectoral legislation. The conferring of these competences will be in full conformity with Articles 226 and 228 of the Treaty. Without prejudice to the application of Community law, and recognising the potential liabilities that may be involved for Member States, decisions under the above mechanisms shall not directly impinge on the fiscal responsibilities of the

Member States. Moreover, any decision by the European Supervisory Authorities or the Commission must be subject to review by the Community Courts."

The above list of ESFS envisaged "enforcement powers" calls for the following remarks:

There seems to be excessive reliance on cooperation and coordination, particularly in the field of "emergency crisis response" where decisive actionable decision making is required. The Fortis case constituted a clear example of the disruption that can be created both by unilateral political decisions (nationalisation of the Dutch assets of the group) and by lengthy procedural delaying tactics (court actions to suspend urgent restructurings). The remedies suggest in the Communication would most likely have been ineffective.

The precise wording of the legislation pertaining to such powers will be a test of the political will of Member States to either pave the way towards the ultimate goal of a fully integrated EU Supervisory system, or to reinforce the powers and independence of National Supervisory Authorities.

Considering that the stated objectives of the ESFS include ensuring a common supervisory culture and consistent supervisory practices, we believe that these aims can only be achieved if supervision is organised formally as a "profession" and that access is subject to minimum common standards of qualification.

These aspects, omitted in the Consultation, deserve to be addressed more fully because there is widespread recognition that failures in the existing supervisory system contributed to the financial crisis. These were due, in part, to "nationalistic" responses by Regulators as well as to the great differences in the training and professional competencies of Supervisors.

We recommend a two pronged approach:

1) The "International Institute of Chartered Supervisors"

As is the case regarding other professions, which exercise special responsibilities in sensitive areas (legal, medical, auditing...), supervision should be organised on a formal basis under the aegis of the "G 20" through the establishment of a dedicated Organisation. It should encompass global, regional and national sections. Sub-sections, reflecting the more specialised areas (corresponding to the three Authorities) could also be envisaged. It would aim at facilitating effective cooperation between supervisory authorities as well promote contacts between individual supervisors.

The Institute would be an appropriate venue for considering "*improvements to existing regulations*", ensuring global "*regulatory compatibility*", setting "*harmonised professional standards*" and agreeing on acceptable "*professional qualifications*". In addition, the Institute should adopt a professional uniform "*code of conduct*" applicable to its Members.

Such a body would also provide a suitable structure in which professional standards can be enforced, (including appropriate sanctions when required) increasing sense of responsibility and accountability of supervisors. At the same time, an appropriate and a suitable distance can be maintained between the profession, the ordinary public judicial process and "political influence".

Such an institution could be an essential building bloc in restoring public trust in the independence, professionalism and integrity of supervisory authorities.

2) An International Training program

A "Public/Private partnership should be developed between Public Authorities - the Institute referred too here above - Academia - and relevant private sector Professions to design a post graduate curricula covering the various aspects of "Financial Supervision" including ethical, legal, technical and governance issues.

The program would be open to holders of university degrees in subjects such as law, economics, accounting etc. as well as to active supervisors with a minimum of practical experience.

In the EU, first year programs should be designed to provide candidates with sufficient familiarity with "national" supervisory regimes, followed by a second year in which a "common curricula" would be dispensed by an appropriately selected Institution of Higher learning, which would draw heavily on competencies from both the public and private sector to strengthen its "Faculty".

In order to provide additional practical experience, the Institute of Chartered Supervisors would organise at least two training periods of 6 months for each graduate to be performed, one with a Supervisor located in the

same region and the other in a different one. In addition to providing invaluable experience, it would also develop better understanding of differences between regulatory regimes and create useful personal relationships that would facilitate cooperation between national supervisors.

It is inevitable that it will take at least a dozen years before obtaining the proposed post graduate "degree in supervision" can be made a compulsory requirement for being appointed to a supervisory position. Implementing the program should, nevertheless, be considered as a very high priority so as to achieve, over time, the stated objectives of more effective supervision.

Conclusion

There is a broad consensus that it is *better* rather than *more* regulation that is required. In order to achieve this objective, it is important to focus simultaneously on the regulatory framework (laws and regulations), the structural architecture (institutions and operating rules), and competencies (training). Accountability and enforceability will be key elements that must be deeply imbedded in the system at all levels.

The comments here above aim at drawing the attention of the Commission on elements contained in - or omitted from – the Communication which deserve to be considered in order to deliver an optimal framework compatible with the political realities.

The undersigned remains at the disposal of the Commission to develop further the ideas described herein.

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- (1) Available on http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.
 - (2) The Fortis case demonstrated the "subordination" of the Belgian Central Bank to the ECB to perform its function of lender to the Belgian Government.
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