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The Reform of Financial Supervision and Regulation in Europe

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1 Introduction

Ladies and gentlemen

First of all, I would like to thank you for giving me the opportunity to speak to you here at the Institute for International and European Affairs. It will come as no surprise to you that the financial crisis will be the main topic of my speech. However, the onset of the crisis lies nearly two and a half years in the past, and we are now seeing more and more signs of stabilisation and recovery. Therefore, I shall leave aside the current state of financial markets and shall instead try to look ahead, focusing on structural issues.

In this regard, the main challenge for the years to come will be to create a more stable and more resilient financial system to prevent future crises. It is obvious, however, that such an ambitious endeavour will not happen on its own. Instead, it requires strong commitment, resolute efforts and broad reforms. Where to begin?

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2 Lessons from the financial crisis

The first step in any serious reform should be to gain a clear understanding of the events that occurred and their underlying causes. Even though it is a tempting thing to do, a crisis of the magnitude we have been witnessing over the past two and a half years cannot be traced back to a single cause. In fact, there could be a hundred narratives, and each would appear to explain the events in a satisfying manner. The most popular of these narratives would revolve around the following explanations for the crisis:

- Gaps in the regulatory framework,
- distorted incentives inside the financial system, such as short-termist remuneration schemes,
- an insufficient resilience of the financial system,
- an institutional design of financial supervision that did not properly reflect the cross-border dimension of crises, and
- a lack of awareness of systemic risks.

All these narratives point to a number of lessons to be learned. And it is these lessons which show us the direction for the reform of the financial system. With regard to financial regulation and supervision, the lessons of the crisis cover, broadly speaking, the following four areas:

- First, we have to improve regulation and supervision at the microeconomic level.

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- Second, we have to pay greater attention to systemic risk control at the macroeconomic level.

- Third, we have to ensure an effective interplay between these two levels of prudential supervision and a cross-check with the analysis of risks to price stability.

- And fourth, the cross-boarder character of the crisis means that we also have to ensure close cooperation between national supervisors.

To put it another way: there is more to a crisis than the microeconomic level, and there is certainly more to it than the national level. Currently, a great deal of effort is being put into transforming these lessons into the necessary reforms. For the remainder of my speech I would like to focus on the European level and comment on some of these endeavours.

3 Institutional aspects of European financial supervision

Within the European Union, much work is being done in establishing a comprehensive financial architecture. Drawing on the lessons learned, this work is pursuing two goals. The first goal is to strengthen the macroprudential level of supervision and ensure an efficient interplay with the microprudential level. The second goal is to strengthen cooperation among member states in the field of prudential supervision. In my following remarks, I would like to give a brief outline of the new architecture, address the role that central banks should play in this framework, and point out some crucial issues that still need to be discussed.

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3.1 Key components of the new European financial architecture

To gain an overview of the key components of the new architecture, let us start at the **macroeconomic level**. Given the urgent need to reinforce the macroeconomic perspective of financial regulation and supervision, the European Commission decided to establish an independent institution responsible for macroprudential oversight across the EU financial system. The main goal of this European Systemic Risk Board (ESRB) will be to avert and mitigate systemic risks to financial stability. To achieve this objective, the ESRB will set up an early warning system to identify the relevant risks. Whenever necessary, the ESRB will then issue warnings and recommendations to deal with the identified risks. These warnings and recommendations could be addressed to the Community as a whole, to individual member states, or to national supervisory authorities.

To strengthen the link between micro and macroprudential supervision, the ESRB will work in close cooperation with the European System of Financial Supervisors (ESFS). The ESFS forms the complementary part of the financial architecture at the **microeconomic level**. Its main goal will be to strengthen cooperation between the national authorities to account for the cross-border dimension of crises that arises from the existence of multinational financial firms or possible contagion effects. With this objective in mind, the ESFS will establish a network consisting of national financial supervisors and three new European supervisory authorities. The new authorities will replace the existing Level 3 Committees and cover each financial sector.

- The European Banking Authority (EBA) will be responsible for supervision of the banking sector,

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- the European Securities and Markets Authority (ESA) will be responsible for supervision of securities markets, and, finally,

- the European Insurance and Occupational Pensions Authority (EIOPA) will mainly be responsible for the supervision of insurance companies.

Although the exact design of the new authorities is still under discussion, the current version of the relevant bill would assign them a mostly coordinative role. Consequently, the main objective of the new authorities will be to improve cooperation and coordination among member states as well as convergence in supervisory practices. In addition, one of their tasks will be to ensure coordinative action in emergencies.

3.2 The role of central banks

Let me now turn to the question of the role which central banks should play in this framework. Owing to the close links that exist between the financial system and monetary policy, central banks have a natural interest in safeguarding financial stability. They also have a high level of expertise in monitoring macroeconomic developments that might impact on financial stability. What the financial crisis also demonstrated was the crucial role that central banks play in restoring financial stability once a crisis occurs. Moreover, in most countries, central banks are directly involved in banking supervision and thus form a natural link between the micro and the macroeconomic levels of prudential supervision. Consequently, they should be adequately represented in the new financial architecture.

In line with the latest compromise on the structure of the **ESRB**, the European System of Central Banks will indeed assume a leading role. With regard to the composition of the General Board, for example, the compromise assigns 29 votes out of a total of 33 votes to

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representatives of the ECB and the national central banks. However, discussions on the final structure of the ESRB are still ongoing, and recent results have shown a tendency to weaken the role of central banks. Let me emphasise here that retaining the pivotal role for central banks, which was envisaged in the original compromise, is of great importance.

Regarding the **ESFS**, it is especially the European Banking Authority where central banks should be adequately represented. This is not yet the case, however. It is planned that only the ECB will be represented on the board. Those central banks that are not the sole supervisor but that are directly involved in banking supervision should have the right to participate in the meetings and take part in confidential consultations.

3.3 Critical issues

The new financial architecture represents a major step towards more harmonised and coordinated micro- and macroprudential supervision within the European Union. A critical question in this context is how macroprudential and monetary policies and their respective instruments should relate to each other. Answers to this question have to be found at both the national and European levels. I have already argued that central banks should be involved in macroprudential policy. Furthermore, an important lesson of the crisis for monetary policy is to keep a closer look on developments on financial markets, given their potentially large impact on inflation and output. At the same time, it is crucial to draw a clear line between the mandate and instruments of monetary policy, on the one hand, and tasks and instruments of financial regulation, on the other. Otherwise, the goal of securing price stability might be compromised. This is why the Eurosystem has made it clear that safeguarding price stability in the medium term remains the primary goal of its monetary policy.

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4 Conclusion

Ladies and gentlemen, with regard to the institutional design of prudential supervision, the lessons of the crisis are clear. First, we have to improve cross-border cooperation and harmonisation. Second, we have to strengthen the macroeconomic perspective of supervision and integrate it properly with the microeconomic perspective. With the establishment of the European Systemic Risk Board and the European System of Financial Supervisors, the European Union has taken a number of steps in the right direction. However, as usual, the devil lies in the detail of the reforms. Here, further efforts are required in order to achieve the goal of a more stable and more resilient financial system.

Thank you for your attention.

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