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European Protection Mechanism against Future Financial Crises

by Marcin Menkes

Learning from the global economic crisis, EU members have reached a long-awaited agreement on establishing a European system of banking, securities and insurance supervision that will become operational on 1 January 2011. The new micro- and macro-economic watchdog will issue warnings of possible financial turbulence, while the EU Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB) are to safeguard against such problems as those encountered during the 2008 crisis as a result of inadequate coordination between EU Member States.

Strive for Truly European Financial Supervision. In the wake of the financial crisis, which ultimately evolved into a global economic downturn, the member States realised that financial stability required international cooperation in the field of financial supervision, as reflected in the G20 commitments. The need for common financial supervision was even more pressing within the Single Market zone—more integrated, yet at the same time more susceptible to turbulence, and it was only under crisis conditions that the EU members were able to make headway in the difficult process of financial markets integration.

The current framework of financial institutions was shaped by the 2000 Lamfalussy Report on the regulatory reform for securities. On this basis the EU adopted a 4-level approach to financial markets integration, paving a way for enhanced coordination in drafting financial legislation. Several institutions were also established, including the Paris-based Committee of European Securities Regulators (CESR), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in Frankfurt-am-Main or the Committee of European Banking Supervisors (CEBS) in London, although coordination with respect to implementing measures and convergence instruments—the so-called 3rd level—remained disappointing As evidenced by the 2008 crisis, Level-3 Committees were incapable of ensuring financial security due to a restricted scope of their powers (mainly advisory) as well as the reserve of national authorities determined to protect local interests. The European Commission appealed for a reinforcement of supervisory mechanisms on a number of occasions, but all initiatives in this respect were rejected by the Member States, which pointed in particular to mutual mistrust amongst national supervisors and an absence of clear rules on burden-sharing in cross-border rescue operations.

Aware of the conflicting interests at stake, the European Commission requested a report on financial supervision (Larosière Report). Its authors shared the Commission's conviction that a supranational mechanism endowed with broad competences would ensure greater financial stability in Europe, arguing that Level 3 Committees had "reached their limits in terms of informal cooperation methods" (Report, p. 77) and calling upon members to create mandatory colleges of supervisors for cross-border companies. They also stressed that any financial sector reform should include the establishment of crisis-management procedures. The Larosière Report also recommended the establishment of a macro-prudential supervision council to provide early warnings to EU supervisors and of another body for micro-prudential supervision; most importantly perhaps, it reiterated that those authorities should be equipped with powers to adopt legally binding decisions, binding technical decisions and legally binding mediations between national supervisors.

The EU Member States and the Commission then started to haggle over the scope of the powers involved[1]. Poland was among the States expressing fears that a transfer of control competences

[1] See: M. Koczor, "Financial and Economic Crisis as a Challenge for Sweden's EU Presidency," *PISM Bulletin*, no. 39 (571), 1 July 2009.

to an EU institution would deprive the national authorities—the sole organ fully acquainted with the situation—of effective measures to influence financial institutions, to the detriment of their clients. It was argued, therefore, that European bodies should be responsible for coordination instead, while the European Commission rightly stressed that the national mechanisms had already proven to be as inadequate as the vague powers of Level-3 Committees.

The compromise hammered out between the European Parliament and the Council on 2–3 September 2010 establishes the first ever supranational financial supervisory system and provides more efficient mechanisms for crisis management coordination between national supervisory authorities.

European System of Financial Supervision (ESFS = ESAs + ESRB). Macroeconomic supervision will be entrusted to the European Systematic Risk Board (during first five years to be headed by the ECB president), whereas microeconomic supervision competences will be shared by three institutions seated in Frankfurt-am-Main, Paris and London, and responsible for insurance companies, trading markets and banks respectively.

The current national supervisor colleges and three Level-3 Committees will be endowed with new control and management powers, evolving into EU Supervisory Authorities (ESAs). These bodies will coordinate—rather than take over—the work of appropriate national institutions. ESAs will intervene only once a national regulator is known to be acting against EU law, issuing warnings first and then—should those remain unheeded—providing instructions to national supervisors or directly to the national institutions concerned. Furthermore, ESAs will be equipped with powers to investigate specific financial institutions, financial products or financial activities, and—whenever necessary—temporarily prohibit a conduct or practice in question. In case of disputes between national authorities, ESAs will impose legally-binding mediation between the parties concerned, and, if no agreement is reached within the appropriate college of supervisors, they will adopt individual binding decisions. ESAs will be able to intervene as mediators at their own discretion, not necessarily at the request of the parties to the dispute.

In order to safeguard efficient and swift communications between national and European counterparts, the ESRB will develop a common set of indicators to permit uniform ratings of the riskiness of specific cross-border financial institutions. It will also establish a colour-coded risk indicator scale to be used together with warnings and recommendations.

Opponents of broad financial integration triumphed by introducing the “fiscal safeguard clause”, which stipulates that ESFS will not exercise its powers in a manner that impinges in any way on the fiscal responsibilities of Member States. This provision stands in clear contradiction with the very notion of control.

Prospects. In line with the compromise reached, the Commission will be required make to regular assessments to determine whether or not the merger of three separate supervision bodies into one is desirable, and whether or not the ESAs should be endowed with further supervisory competences, notably over financial institutions with a pan-European reach.

The new procedure is somewhat more democratic, as the consent of the European Parliament will be needed to choose ESA chairpersons, and the EP will also participate in developing technical standards and implementing measures. The ESRB president will keep the chair and vice-chairs of the EP’s Economic Affairs Committee updated on ESRB activities through confidential discussions.

Whereas some feel relieved that supervision will not be taken over by European institutions, as this raises concerns over financial responsibility for the efficiency of supervisory measures, others welcome the latest change as a necessary step towards a reconstruction of current supervision mechanisms, which have failed terribly on one occasion already. While it seems that the momentum was used to push the reform agenda forward, reticence in other respects (including talks on hedge funds or offshore funds) raises doubts if we are really facing a new era of European financial integration. As for ESFS efficiency, it seems that the most important task now will be to overcome national reticence, which could paralyse the new institutional framework.