SPEECH

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Towards a new European supervisory structure

Ladies and gentlemen

Let me start by saying that I consider it a great honour to have been invited to speak to you today. We work in different parts of the world, but I think that the crisis that we are now struggling to get out of has shown, for good and bad, that the financial system has brought us closer together than ever before.

Over the course of last year, there is one sentence that has really burnt into my brain. It was delivered by Mervyn King, the governor of the Bank of England, who has a great talent for one-liners. He concluded on one occasion, somewhat disillusioned after having dealt with the failure of a number of cross-border institutions, that "global banks are international in life but national in death". And indeed he is right. We have banks and other financial institutions that work all across the globe. But when they get into trouble the instruments for safeguarding financial stability essentially remain fragmented along national borders.

This geographical mismatch is something that the regulators will have to deal with, one way or the other. And to put it bluntly, from a policy perspective it basically boils down to a choice between two paths. On the one hand we can choose a path towards fully-integrated international regulatory and supervisory structures, in order to achieve a better match with the global format of the financial system. On the other hand, we can choose a path towards shrinking the financial system back inside national borders, within the perimeters of current regulatory and supervisory arrangements. Obviously, reality will not be as black and white as to make a simple choice between these two paths possible. Future regulatory reform will probably take some kind of middle road. But if someone asked me for directions my answer would be clear. The benefits of financial globalisation are too great for us to afford to close national borders and to roll back financial integration.

A new European supervisory structure – the de Larosière proposals

As you all know, the European Union chose its path already some time ago. Based on the belief that integrated markets contribute to economic growth (and

also to other important policy objectives) the European Union has established a legal and institutional framework for the supervision and regulation of financial markets. However, even though we have come a long way towards establishing a single European market, the regulatory and supervisory structures are still very much fragmented along national lines – a fact that we have been painfully reminded of during the current crisis. The problems experienced with the Icelandic banks and the Benelux-based conglomerate Fortis are just a couple of examples.

To address these problems the European Commission last fall initiated a fundamental overhaul of the EU supervisory structure. A group chaired by the former head of the IMF, Mr. Jaques de Larosière, was mandated to come up with proposals for needed reform. The recommendations made by the group were broadly embraced by the EU member states and we are now at that stage in the process where final details are being negotiated. The new supervisory structure will rest on two pillars.

The first pillar – micro prudential supervision

The first pillar consists of several initiatives to strengthen micro prudential supervision in the EU. Regulatory measures at the EU level shall ensure strengthened and more consistent supervisory powers at the national level. Supervisory colleges will be mandatory for all the major cross-border firms in the EU. Differences in national laws will be indentified and removed. All these reforms will take place within the new European supervisory network, the *European System of Financial Supervisors (ESFS)*. The main element of this reform is the transformation of the three existing EU supervisory committees into independent EU authorities. These authorities will form a central hub of the European supervisory community and will be equipped with both regulatory and supervisory powers.

The day-to-day supervision will still be a national responsibility and carried out on a decentralised basis. The new authorities are therefore primarily to be seen as a complement to the national regulators and supervisors and not as a replacement. However, in a few areas the EU authorities will be able to make binding decisions which have a direct effect on national regulations and supervision:

- First, in the area of regulation, the authorities will develop binding technical standards to promote uniformity in the implementation and application of EU-law.
- Second, the EU authorities will be equipped with powers to address national supervisors that are considered to be diverging from the existing community legislation. If it is deemed that the supervisor concerned is not in compliance with EU law, then the authorities will be able – as a last resort option – to adopt decisions directly applicable to the supervised financial institutions.
- Third, in areas where EU law requires co-ordinated decision making between home and host supervisors the authorities will be able to make binding decisions directly applicable to individual institutions if supervisors cannot reach a joint decision (for example on the validation of Basel II internal models).
- Fourth, in the event of a crisis situation the authorities will be able to make certain emergency decisions requiring national supervisors to jointly take specific action.

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- Finally, the EU authorities will be awarded full and direct supervisory powers over credit rating agencies.

Besides these binding powers the authorities will also have other "soft" instruments to promote and strengthen harmonisation and co-operation. For example, the authorities will be able to participate as observers in all supervisory colleges. They will also conduct peer reviews of national supervisors and issue recommendations on the basis of the outcomes. In the regulatory area, they will be able to issue non-binding guidelines on the implementation of EU law.

The second pillar – macro prudential supervision

The second pillar is the establishment of a new European body responsible for macro prudential supervision. The European Systemic Risk Board (ESRB) will be mandated to identify and assess systemic risks on a European-wide basis. Having a common body that provides a "birds-eye view" of financial system risks will help to avoid repeating the mistakes made during the current crisis, where both regulation and supervision focused too much on individual institutions and markets. Also, by looking at risks arising from macro economic trends, as well as from developments within the financial system, the ESRB can identify threats to financial stability coming from both endogenous and exogenous factors.

On the basis of its analysis, the ESRB will issue specific risk warnings as well as recommendations for policy action to address the identified risks. These will be directed to those institutions that have the power to take corrective action. This could include member-state governments or authorities, the European Commission or other EU bodies. Warnings and recommendations will not be binding. Instead they are expected to be followed on a "comply or explain" basis. On a case-by-case basis the ESRB will decide if warnings and recommendations should be disclosed to the public.

In terms of composition the ESRB's decision-making body will consist of the governors of all the EU central banks, including the President of the ECB, as well as representatives from the European Commission and the three new EU supervisory authorities. National supervisors will be represented in the ESRB, but not have any voting powers.

Taken together these pillars imply quite substantial changes in the EU supervisory structure. And even if there is broad agreement among member states on the overall concept, some parts remain highly controversial. The issue of handing over power to the EU supervisory authorities is particularly sensitive. Some member states argue that this cannot be done unless guarantees are in place that it will not impinge on national fiscal responsibilities. Hopefully, the Swedish Presidency will be able to sort out these issues and make its ambitious implementation plan a reality. If so, an agreement will be reached by the end of this year and the new supervisory structure will be up and running already during the course of next year.

Supervisory reforms need to be complemented by robust and harmonised frameworks for crisis management and resolution

After going through this list of reforms you may ask to what extent they will actually work in practice to promote and maintain financial stability within the EU? A number of questions can be raised, of course, but overall I would say that it

looks very promising. However, I would like to point to one very important piece that needs to be put in place to make this system effective, namely a common framework for dealing with troubled cross-border financial institutions. Here, I would like to raise the perspective from the EU to speak more broadly on the need for action at a global level.

The reason why I propose that supervisory reforms need to go hand in hand with reforms in the area of crisis management is quite simple. Supervisory and regulatory incentives are largely driven by what will happen once a crisis occurs. Essentially, it all comes down to the questions of who will suffer and who will pay. As is currently the case with crisis management arrangements fragmented along national lines, the answers to these questions are highly uncertain. The best guess is that countries, in the absence of a common framework to tackle the problems, will try to minimize their own losses and costs without giving due consideration to the impact on other countries. And if regulators and supervisors suspect that costs will be pushed unfairly to their side of the border in a crisis, this suspicion will no doubt influence their view of cross-border banking.

Basically, what I am saying is that if we cannot find a way to improve and clarify the way we deal with troubled cross-border banks then not very much will be gained by strengthening the harmonisation and co-ordination of regulation and supervision. In the worst case, this may even lead to a situation with a more fragmented and nationally-oriented regulatory and supervisory system. To paraphrase the quote from Mervin King: global banks would still be national in death, but less international in life. That would, in my view, be a step backwards.

I do of course realise that it is unrealistic to ask for the creation of an international institution with supranational powers to deal with distressed cross-border banks. So, in the absence of a common global regime the best we can do is to try to develop a *common international approach* to crisis management and resolution. If we cannot do it as one, at least we need to make sure that we can do it similarly and in a coordinated fashion.

So we need to embark on an even bolder agenda than the present supervisory reforms. Here, we may draw some inspiration from the last century. After the war we created the IMF to provide some basic rules for the monetary system, recognising that the system is interlinked and that problems in one country may also create problems in others. In the 1980s we agreed on the Basle Accord with joint supervisory rules for the internationally-active banks. Recognising now that supervisory convergence hinges on agreement on crisis management and resolution, I think that it is time to address this issue in a serious way. I see this as a necessary step for Europe, given our single market. But in a broader context too, it will be a natural step towards strengthening the global financial system.

Thank you