

***EUROPEAN COMMISSION CONSULTATION ON THE FUTURE OF FINANCIAL SERVICES
SUPERVISION IN THE EU***

IMF STAFF POSITION ON THE DE LAROSIÈRE REPORT¹

Washington, DC—April 10, 2009

This submission should be seen as part of the IMF staff's work in the context of its regular surveillance of the EU and its member states. As such, it is focused on the recommendations of the De Larosièrè report (henceforth the "Report") that concern EU economic and financial policies. It is not intended to comment on the global recommendations of the De Larosièrè Group (henceforth the "Group"), or on the Group's recommendations with respect to the role of the IMF.

A. General comments

We support the thrust of the Group's proposals and, in general, recommend their quick implementation. We also have some important suggestions for further improvements, based on our view that the EU needs an integrated, dynamic, efficient, and innovative financial system. The rationale in favor of a single EU financial market remains compelling.

A single financial market requires integrated financial stability arrangements. The reason is two-fold. First, financial intermediation is shaped by financial stability arrangements, notably regulation and supervision. Hence, the choices that the EU will make during the next few months in response to the crisis and the de Larosièrè report will determine the kind of financial system Europe will have in the future, notably its degree of integration. Second, the nature and potential impact of financial risks depend on the degree of cross-border financial integration. What the EU needs is financial stability arrangements that enable the development and integration of its financial system, while containing the related risks.

These arrangements need to be effective and efficient, but also politically appealing. They need to cater to the legitimate interests of each member state, and prevent or overcome divergences in interest between member states. We have argued in the past that doing so in ways that are consistent with a single financial market requires joint responsibility and joint accountability for financial stability.

¹ The views expressed herein are those of the staff of the IMF's European Department, with input from staff of the Monetary and Capital Markets Department and the Statistics Department. These views should not be attributed to the IMF, its Executive Board, or its management.

Most of the recommendations of the Group are consistent with progress toward these objectives, which motivates our support. We also accept that speed is of the essence. However, we have some questions and concerns about the extent to which the recommendations are capable of delivering a truly integrated financial market.

Our main concern centers on the fact that the Group has accepted as given that national authorities are responsible for crisis resolution. This implies that, for EU member states, cross-border banking requires an uncomfortable degree of dependence on each other's decisions, financial stability arrangements, and deposit insurance schemes, which inevitably causes diverging interests, tensions, and problems in times of crisis. Alternatively, it requires financial stability arrangements that are consistently organized on a national basis, which precludes free cross-border banking through a "single passport". The former option no longer seems tenable in light of recent experience, whereas the latter option constitutes a major obstacle to establishing a single financial market. In the absence of more fundamental reforms, the inevitable outcome of the review that the Group proposes (Recommendation 14) will be greater host country control over the activities of foreign banks, which will constitute a major setback to existing and future financial integration. As pointed out by the UK's Financial Services Authority in its Turner review, it may also result in a discriminatory situation in which only banks from large countries can benefit from the single passport.

We thus see the report putting the single passport in question. This matters, because branch-based cross-border banking has been an important driver of financial integration. More importantly, it is a driver whose potential was only recently greatly enhanced, as the 2004 coming into effect of the European Company statute made it possible for financial institutions to organize branch-based cross-border operations much more efficiently. We agree that there are inherent problems with such operations as currently organized under the single passport, but in our view these problems can and should be resolved without undermining the single passport itself. The rationale for having a single financial market with a single passport is much stronger than the rationale for maintaining the status quo on crisis resolution. Moreover, we are concerned that the tension between the Group's bold proposals on supervision and its modest proposals on crisis resolution risks being an obstacle to the implementation of the Group's recommendations as a package.

The way out is to create a cross-border safety net for cross-border banks. This is not impossible. Technically, there are many available options. The challenges are to find solutions that are politically acceptable and incentive-compatible. In October 2007, the ECOFIN adopted a set of crisis management principles. These principles are, in many ways, an important part of the solution. The problem is that the incentives are missing for decision-makers to adhere to these principles in the heat of a crisis. What is needed is a framework that ensures the consistent implementation of these principles.

As discussed in the report (para. 218), the Group considered the possibility of introducing a two-tiered supervisory system, with EU-level supervision of cross-border groups. However, the Group did not see irrefutable arguments in favor of such an approach and doubted that it could be implemented at this juncture given the complexities and costs, the political implications, and the difficulty of resolving cross-border burden sharing.

However, the essence of a two-tiered system is not two-tiered supervision. It is having a cross-border safety net for cross-border financial institutions. We agree that implementation of such a system is not possible in the short run, because of the challenges that the Group points out. However, we also see no possibility to achieve a single financial market in the EU without a cross-border safety net. Hence, the choice that lies ahead is to either move in that direction or accept that a single financial market will remain out of reach. Besides seeing a stronger case for a two-tiered system than the Group, we are also more confident that the related challenges can be tackled within a reasonable timeframe. Greater political integration would undoubtedly help, but is not a prerequisite.

While the proposals of the Group offer much potential for progress, they would result in a heavy organizational structure combining national and supra-national agencies as well as colleges and other bodies. Over time, possibilities to achieve more streamlined arrangements and efficiency gains should be explored.

B. Specific comments

An effective EU financial stability framework should comprise the following elements: (1) macro-financial oversight and policies; (2) sound financial regulation; (3) micro-prudential supervision; (4) tools for corrective and preventive action and crisis management; (5) cost-efficient resolution mechanisms for dealing with failing institutions; (6) a robust financial infrastructure; and (7) information systems to support both micro- and macroprudential monitoring. The optimal design of each of these elements depends on the design of the others. Hence, regulation, supervision, and macro-financial oversight, which have been the Group's main areas of focus, cannot be considered in isolation.

Macro-financial oversight and policies

The crisis has demonstrated the need for much greater attention to aggregate financial risks and for the interaction between financial and real economic developments. It has also demonstrated the need for analysis of such risks and developments to feed into micro-prudential regulation and supervision. Institutionally, this translates into a need for close ties between supervisors and central bankers.

The Group proposes setting up a European Systemic Risk Council (ESRC), which would be closely linked to the ECB and be composed of the members of the General Council of the

ECB/ESCB, the heads of the Level 3 Committees / Authorities, and the Commission. Such a body has the potential to address the need for better macro-financial oversight in the EU, and we support its establishment.

The key challenge will be to ensure that the ESRC can operate effectively and that its assessments are reflected in corrective policies throughout the EU. From this perspective, we have the following remarks:

- It will be essential that the ESRC be independent, possess effective powers, and have adequate resources.
- Given its size, the ESRC will need strong leadership and streamlined decision-making mechanisms. At the same time, care will need to be taken that the interests of individual countries and minorities are looked after.
- Follow up will be crucial. In this regard, the participation of the chairpersons of the Level 3 Committees / Authorities in the ESRC (Recommendation 16) is essential. However, it is questionable whether such high-level interaction with the ESFS is sufficient. The relationship between the ESRC and the national supervisors, by contrast, appears awkward. If we interpret the Report correctly, member states would be represented either by their central bank or by one of their supervisory bodies depending on the circumstances (para. 179 and Recommendation 16). Better ways should be found to involve national supervisors in the ESRC's work without compromising the participation of central banks.
- The ESRC will be a high-level body. For it to function well, extensive links and information flows will also need to be established at lower levels, in particular between supervisors and central banks in the member states, and between the ECB and the European System of Financial Supervisors (ESFS, see below) at staff level.
- The report envisages the participation of ECB/ESCB staff in colleges of microprudential supervisors as well as in relevant on-site inspections. In our view, this is essential to ensure an adequate exchange of non-standardized information between central bankers and supervisors.
- The report further recommends "mandatory follow-up" to microprudential risk-warnings issued by the ESRC, which is bolstered by oversight through the Economic and Financial Committee (EFC) (recommendation 17). In particular, if specific risk warnings and the ESRC's advice on policy responses are not heeded, the ESRC can refer the matter to the ESC, which can in turn involve ECOFIN, or make public the ESRC's recommendations. In this set-up, much will depend on the cooperation of the member states. It is also not clear that minority interests will be safeguarded.

- A crucial challenge is that of maintaining stability in individual member states with a large foreign bank presence. Under current home-host arrangements, the host authorities of such countries have only limited tools at their disposal to tackle risks to financial stability in their domestic market. The single market objective makes it undesirable to address this problem through increased host country powers or country-specific regulations. The ESRC, working with the ESFS, could and should offer superior solutions. When country authorities are concerned about the development of potential systemic risks in their domestic market, they should be able to appeal to the ESRC with a request to formulate a policy response. Such a response could, for example, take the form of ESFS guidance issued to all EU banks to raise the capital charges on credit provided to residents of that country. There should be a presumption that the authorities' assessment is correct and that a response needs to be formulated.

Regulation

A single financial market requires a single rulebook, so as to allow financial institutions to operate across borders without having to adapt their operations to the specific rules that apply in each member state. The crisis has further reinforced the case for a single rulebook, by showing the potential harm that regulatory arbitrage can cause.

The Report advocates “a harmonized set of core rules” (Recommendations 10 and 20). This is to be achieved by 2013 through a thorough review of existing legislation and cross-country differences. To maintain this harmonized set of core rules in the future, it recommends better future legislation and better-functioning Level 3 Committees / Authorities. However, the report also states that member countries “should be able to adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability” as long as the principles of the single market and agreed minimum core standards are respected (Recommendation 10).

These proposals would constitute significant progress toward the objective of a single rulebook, but fall appreciably short of it. They risk turning into a one-time effort to achieve greater harmonization of existing rules, without assurances that this harmonization will be maintained over time. In a single financial market where institutions regulated by different home regulators operate alongside each other in the same national market, we see very limited scope to use country-specific regulatory measures or exceptions as a means to achieve domestic financial stability objectives. Therefore, we do not see much merit in the report's relatively favorable position toward more stringent national regulatory measures. As indicated above, the ESRC and ESFS offer superior alternatives.

In our view, a more comprehensive overhaul of the way financial regulations are established is a prerequisite to achieve and maintain a single rulebook. On this point, the Turner review

appears to offer a better solution, with its proposals to transform the Level 3 committees in what would in essence be a European financial regulator. We see merit in merging aspects of both sets of proposals, by establishing one or more pan-European bodies that combine the supervisory roles proposed by the Group for the ESFS Authorities with the regulatory roles of the EU-level regulatory body proposed in the Turner review.

The text of the Group's report (para. 109) argues in favor of using directly applicable EU regulations rather than directives wherever possible. While this suggestion is not endorsed in the Group's official recommendations, we see considerable merit in pursuing this idea.

Supervision

In an integrated market, supervision needs to be effective, notably in dealing with cross-border risks; cost-efficient for taxpayers as well as supervised entities; organized in ways that allow the smooth operation of financial institutions across borders; and geared toward reconciling and safeguarding the interests of both home and host countries.

The Group proposes establishing the ESFS, bringing together the national supervisory agencies and three new independent supranational Authorities (Recommendation 18). Supervision would remain at the national level, but be organized through colleges for cross-border groups and be subject to binding guidance and other forms of control by the Authorities.

The ESFS would be a major step toward a more integrated system of supervision. Its main advantages lie in its potential to greatly improve the effectiveness of cross-border supervision and to defuse tensions between home and host country authorities. However, to realize this potential, it is essential that the ESFS Authorities be given adequate resources, independence, and binding powers over national supervisors as proposed by the Group. Provided those conditions are fulfilled, we support the establishment of the ESFS.

We have the following additional remarks and observations:

- The report moots a possible early transformation of the ESFS Authorities toward a twin-peaks model (Recommendation 24). We agree that such a model would be preferable over a sectoral approach. We understand that the Group's main motivation for recommending an initial sectoral structure based on the Level 3 committees is the need to proceed quickly. However, this has to be weighed against the risk of indefinite postponement of a move toward a more desirable structure and against the challenges to ensure adequate cross-sectoral coordination and supervision with three separate Authorities.
- National prudential agencies will have to work closely and in tandem with the future EU-level agencies. To allow this, some thought needs to be given to the organization

of supervision at the national level so as to ensure effective and efficient cooperation within the ESFS. If the ESFS will, over time, move toward a twin-peak structure, there might be major advantages in EU member states mirroring this in their national arrangements.

- To ensure smooth cooperation and consistent objectives, it would be very useful to give the national agencies an explicit and strong European mandate spelling out their responsibilities within the ESFS.

Early intervention, crisis management, and crisis resolution

Solid, equitable, and cost-efficient arrangements for cross-border crisis management and resolution are essential to establish and maintain a single financial market. Only with such solid arrangements in place will countries have sufficient trust and confidence to durably accept the interdependencies that a single financial market implies. Cost-efficiency in turn requires tools that allow early intervention in a troubled financial institution.

The recommendations of the Group in this area have to be seen in the context of the recent and ongoing efforts to improve crisis management and resolution in the EU. Cornerstones of this work are the ECOFIN crisis management principles adopted in October 2007, the June 2008 crisis management MoU, the forthcoming White Paper on Early Intervention (due in June 2009), and other initiatives under the ECOFIN Roadmap on crisis management. While these initiatives are to a large extent work in progress, it is generally accepted in both public and industry circles that the EU's cross-border crisis management arrangements have performed poorly during the ongoing crisis. Notably, country authorities have found it difficult to live up to their commitment to the ECOFIN crisis management principles in the heat of a crisis, when their incentives push them toward prioritizing the national interest.

In addition, national crisis management and resolution frameworks have in many cases proven inadequate to deal effectively and cost-efficiently with troubled and failing institutions. In several cases, governments ended up being forced to negotiate with shareholders over the fate of an institution that, in the absence of government support, would have no shareholder value left.

Against this background, the Group recommends:

- A coherent and workable regulatory framework for crisis management in the EU, comprising “a transparent and clear framework for managing crises”, “appropriate and equivalent crisis prevention and crisis intervention tools” and a removal of legal obstacles that stand in the way of using these tools in a cross-border context (Recommendation 13).

- Harmonized, pre-funded deposit insurance schemes that offer equal and high protection (Recommendation 14).
- More detailed criteria for burden sharing, to be incorporated into an amended version of the June 2008 MoU (Recommendation 15).

The clear calls for harmonized deposit insurance and detailed criteria for burden sharing are welcome steps forward. However, the recommendations in this area suffer from the absence of a holistic view on how to address cross-border crisis management and resolution in a single market. The recommendations of the Group do not go much beyond an endorsement of the ongoing work under the ECOFIN Roadmap, and accept as given the constraints under which this work is proceeding, notably the absence of an EU-level mechanism for financing cross-border crisis resolution efforts.

The consequences of accepting these constraints are far-reaching. They include undermining the single passport with the call to review the powers of host authorities over cross-border branches (Recommendation 14), leaving in place existing incentives toward non-cooperation in crisis situations, and failing to achieve progress toward better adherence to the ECOFIN crisis management principles.

In our view, the lessons of the current crisis and the objective of a single financial market call for a much more fundamental rethink of cross-border crisis management and resolution in the EU. As we have argued in the past, tackling this crucial problem decisively is key to completing Europe's single market project.

More specifically:

- We do not agree that the absence of EU-level mechanisms for financing cross-border crisis resolution efforts is an insurmountable problem. EU member states have already committed themselves to the principle that crisis resolution costs should be shared as part of the ECOFIN crisis management principles. It is a relatively small step to move from this commitment to more concrete mechanisms.
- Moreover, the availability or not of public funds should not be at the center of the policy debate in this area. Various options exist to reduce or eliminate the need for public funds and to share the burden. Ways to reduce the need for public funds in crisis resolution include improved regulation and supervision; early intervention mechanisms; special resolution regimes for banks; and pre-funded, private, or mutual solvency insurance schemes. In this regard, the upcoming Commission White Paper on Early Intervention could potentially be of great significance.

- Urgent efforts are needed to introduce special resolution regimes at the national level. Some EU member states have already gone ahead with this, but harmonization of these national regimes could be an important step towards a more effective framework for cross-border resolution.
- A pre-funded European Deposit Insurance Fund (EDIF) could be considered to insure cross-border deposits or deposits of cross-border institutions.
- Thought could be given to schemes that provide prefunded insurance against the realization of systemic risk.
- The crisis has shown the need for independent input and expertise in crisis management, to overcome the lack of experience and specialty knowledge of those who have to make the final decisions, and to foster adherence to the ECOFIN crisis management principles. Consideration should be given to establishing a crisis management cell that can fulfill this function, perhaps as part of the ESFS or ESRC.

Information sharing

Information is crucial to the functioning of financial stability arrangements, at both the macro and micro levels and in both normal and crisis times. While emphasizing the need for information, the Group does not recommend a fundamental change in the way information is collected and distributed among European supervisors. However, it does recommend a pooling of macro-prudential information at the ESRC and a proper flow of information between the ESRC and the micro-prudential supervisors (Recommendation 17).

We are of the view that there is also a need to pool and better manage and distribute micro-prudential information. Currently, no single authority has a comprehensive overview of risks in the EU's main cross-border groups. Prudential information on EU financial groups is collected locally, according to different methods, and is not centralized. Even within countries, information is often spread over multiple agencies. The crisis has also highlighted that central banks, and the ECB in particular, require information about the condition of financial groups in order to detect risks and facilitate liquidity support. Control over information and incomplete datasharing can be key factors impeding cross-border cooperation in crisis prevention, management and resolution. Also in non-crisis times, information sharing has not always functioned as provided by the present arrangements.

Arrangements for information exchange within a decentralized structure will always be less effective than having all information centralized in a standardized format, so that it is subject to a full overview by the proverbial single pair of eyes. A system of simultaneous and parallel reporting to, on the one hand, the national authorities, and, on the other hand, to all members of the supervisory colleges and the relevant central banks, should be envisaged.

Two elements seem necessary to establish such a system:

- A European confidentiality regime covering all prudential authorities and central banks, specifying which parties are entitled to what information and providing EU-wide safeguards for data confidentiality without impeding cross-border information flows.
- IT systems that assure the immediate distribution of prudential data from the moment they are reported by a financial institution to all the parties who are entitled to have access to that information according to the rules of the abovementioned European confidentiality regime.

C. Other issues

European versus global solutions

There are two policy areas (credit rating agencies and credit derivatives) where the report opts for a European solution, without giving much consideration to the alternative of a global solution.

Credit rating agencies (CRAs). Within the EU, a strengthened CESR (Committee for European Securities Regulation) is proposed to be in charge of registering and supervising CRAs (para 67). The report also notes that far-reaching changes are needed to address incentive issues (moving from “issuer pays to buyer pays”) that should be addressed at the international level (para 68). It is unclear however, at what level other proposals included in the report, such as a reform of ratings scales (para 71) are meant to be resolved. An alternative model that is not discussed in the report, but that might merit consideration in view of the global role of ratings is to subject CRAs to oversight by an international body. This could be organized either as a new authority or as an international college of supervisors, involving securities regulators from the main financial centers in addition to IOSCO. The recommendations of the recent NYU White paper to establish an (international) clearing mechanism for those seeking a rating could also be studied in this regard.

Securitized products and derivatives markets. The report proposes to introduce and require the use of at least one European clearing house for credit default swaps, which would be supervised by CESR and the ECB (para 94). While a central clearing house is a welcome recommendation, it raises the questions whether in view of the global nature of the OTC derivatives market, a global clearing house might be preferable and, if so, how such a global clearer could be supervised. IMF staff do not mean to prejudge which of these alternatives offers the best trade-off with regard to both efficiency and mitigation of systemic risk.

Moreover, the current momentum towards the establishment of central counterparties is welcome and should be preserved. Further debate may, however, be useful in the longer-run, again, preferably at an international level.

Statistics

We support efforts to improve the data available for monitoring financial stability. The IMF has created and chairs an inter-agency group on economic and financial statistics that is considering data needs arising from the crisis. Further, the IMF along with the FSF has been asked to explore gaps and provide appropriate proposals for strengthening data collection before the next meeting of G-20 Finance Ministers and Central Bank Governors.

However, the work involved in developing an international risk map and credit register (Recommendation 27) should not be underestimated. Indeed, we are not convinced that setting up and maintaining an international credit register would prove to be an effective use of statistical and regulatory resources at this time, and at best could only be considered a long term objective.