

Nout Wellink: A new structure for European and global financial supervision

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the 37th Economics Conference, Vienna, 14 May 2009.

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Introduction

Reporters repeatedly ask me about my thoughts on the economic downturn. How protracted will the economic recession be? Will there be prolonged deflation? These are valid questions – questions we have all been asking ourselves over the past months. Fundamental questions about what we learn from this crisis are less frequently asked, yet these are exactly the questions we should be asking ourselves now. The organisers of this long-standing, excellent economics conference understand that all too well. Today and tomorrow, we will go beyond the crisis and look at the economic policy agenda for the years to come. This morning, I present my views on the appropriate structure of European and global financial supervision. I restrict myself to the institutional lessons to be learned and the institutional challenges to be tackled.

European perspective

Starting from a European perspective, for some time now there has been widespread agreement that the existing institutional set-up in Europe is unsustainable. The ongoing crisis has strengthened this view considerably. While large European financial institutions are cross-border in nature, the supervisory system in Europe clearly is not. Financial supervision remains the remit of national member states. Differences in financial supervisors' national mandates threaten the level playing field in Europe. And because financial supervisors operate under strictly national incentives, information-sharing and cooperation between them has not been sufficient. Up to now, macro-prudential supervision, which is aimed at limiting the frequency and severity of financial distress, has not only been too weak in Europe, but also too decentralised. This stands in contrast with other policy areas, in particular monetary policy, where decision-making is centralised and based on a much stricter analytical footing. Finally, most European central banks have published macro-prudential risk warnings. These have been ineffective, however, as has been painfully revealed by the crisis. We have learned that such warnings are not effective unless they are translated into action and that we need to pay more attention to system-wide risks.

In light of these and other lessons, a high-level group chaired by Jacques de Larosière recently made specific proposals on the structure for financial supervision in Europe. According to the De Larosière group, a European Systemic Risk Council should be set up to strengthen macro-prudential supervision. Likewise, the group recommends establishing a European System of Financial Supervisors to strengthen micro-prudential supervision. I would like to express my support for a quantum leap with respect to financial supervision in Europe, taking the De Larosière report as the starting point.

Recommendation ESRC

Let me begin with their proposal for a European Systemic Risk Council, a body that would be in charge of performing macro-prudential supervision, issuing risk warnings and giving recommendations on policy measures. While the idea of such a Risk Council is broadly

welcomed, it also has encountered criticism. There have been comments on the Council's suggested mandate as well as on its institutional design.

Regarding the suggested mandate, there is the notion that the Council should refrain from giving binding macro-prudential policy recommendations. While the key pillars of macro-prudential supervision are regulation, financial supervision, and monetary and fiscal policy, the Risk Council itself has no responsibility for these tasks, nor any decision-making powers. However, what the Risk Council can and actually should realise is better macro-prudential analysis at the European Level. It should communicate its findings to the competent bodies and monitor the follow up by the relevant authorities. Let me now be a bit more specific.

First, we have to come up with a clear definition of macro-prudential analysis. Only when we have agreed on the definition of macro-prudential analysis can we determine the scope of the Risk Council's mandate. Ideally, the Council's mandate would be broad. After all, the areas determining system-wide risk are widespread. To be effective, macro-prudential analysis should not be limited to current risks but also examine the systemic impact of general developments in financial innovation, financial regulation and market design.

Moreover, the Risk Council should be able to identify how risks are distributed in the financial system, evolve over time and can be amplified within the financial system and by interactions between the financial system and the real economy. The Risk Council should therefore have access to the necessary information, although there are constraints to information-sharing. For instance, sharing firm-specific data could prove problematic. Unfortunately, exactly this type of information is essential to macro-prudential supervisors. Firm-specific data allows for better analysis of the magnitude and distribution of key risks and also provides insight into the inter-linkages between different financial institutions. So, in the interest of macro-prudential analysis, we have to find a workable solution to firm-specific data sharing at the European level.

Crucial in the whole process is the translation of the macro-prudential risk analysis into Risk Council conclusions. Contrary to what the De Larosière group proposes, these conclusions cannot – for reasons of governance – be binding. For the Council conclusions to be effective, it is important that these are clear, concise and directed to the relevant authorities, such as individual supervisors and Member States but also European bodies like the Council of Ministers and the future European System of Financial Supervision. Needless to say that the Risk Council should monitor and evaluate the follow up given to the Risk Council's conclusions. The Risk Council should be entitled to give its opinion on the measures taken, if necessary on a confidential basis.

The second criticism of the Risk Council is of a more institutional nature. Regarding the composition, a complaint is that EU central banks will be overrepresented and EU supervisors will be underrepresented in the Risk Council. Frankly, I agree. Inviting ECB General Council members to sit on the Risk Council, while national supervisors are only represented by the three presidents of the Supervisory Authorities makes the balance uneven. Equally important is that this proposal does not do justice to the importance of supervisory information for macro-prudential analysis and underestimates the importance of a real dialogue between central banks and active supervisors. However, with more than 50 national supervisors in the EU, it is important to strike a balance between participation of supervisors and the effectiveness of the Risk Council. If membership is extended to national supervisors we can perhaps involve them on a rotation basis. It goes without saying that the chairs of the European level three committees (the future Authorities) should become full and permanent members of the Risk Council. An issue to address is whether the national supervisors should have voting rights. Here I hesitate; after all, macro-prudential supervision is the primary responsibility of central banks.

This brings me to the choice for the ECB president as chairman of the Risk Council. Non-euro area EU countries have opposed this, as it would exclude the possibility that one of their

representatives would chair the Risk Council. However, I am still of the opinion that the ECB president is best positioned in the EU to chair the Risk Council.

Third, there is also still lack of clarity on the working procedures of the Risk Council, including the preparation of its meetings. Here, I see a role for the Banking Supervision Committee, at present an ESCB body, composed of EU central banks and financial supervisors. The Banking Supervision Committee can only play this role if its mandate and composition are changed. The mandate of the BSC would be to present clear risk analyses to the Risk Council, even if controversial. The cross-sectional dimension of the financial system also pleads for expansion of BSC membership to include supervisors of insurance, securities and pension firms. This could be achieved through participation of one representative of CEIOPS and CESR, similar to the current participation of CEBS.

Recommendation ESFS

The De Larosière group has also given advice on how to address shortcomings in the micro-prudential supervisory structure. In this respect they propose to set up a European System of Financial Supervision, being a network of national supervisors and so-called European Authorities. These European Authorities would be the successors of the current Level 3 Committees CEBS, CEIOPS and CESR. The Authorities would continue to perform all the functions of the Level 3 Committees but, in addition, would carry out a number of specific new tasks. As there are many, I will not go over them one by one. The crucial point is that these new tasks would bring about a transfer of decision-making powers from the national to the European level. Notably, the group advises the European Authorities to have binding mediation powers in case of cross-border disputes between national supervisors.

I fully agree with the group that stronger cross-border supervision in Europe is highly desirable. In fact, I would be in favour of even more far-reaching proposals towards supranational supervision in Europe. But only if the necessary requirements for such a historical move are fulfilled. The most important requirement concerns the issue of burden-sharing. Indeed, the Achilles' heel of this part of the De Larosière report is that too little is said about this central issue. Before we can transfer decision-making powers to the international level, we really should first agree on burden-sharing arrangements. So the advice on the European System of Financial Supervision is not sufficiently balanced. I see two solutions to this. One is to decide on EU burden-sharing arrangements, which is of course easier said than done. The other, second-best solution would be to strive for the time being for less decision-making powers at the European level than has been suggested by the group, and working hard on solutions for the burden sharing issue.

I am in favour of burden-sharing arrangements at the European level, though fully aware of all the difficulties involved. But if the end goal is European supervision for pan-European financial institutions, there is no alternative. For burden sharing arrangements to be credible, they should be legally binding and preferably enshrined in the Treaty. It is a misconception that effective burden-sharing arrangements can be made in Memoranda of Understanding. Burden-sharing arrangements should also be incentive-compatible. To this end, a mix of general and specific burden-sharing is preferable. Under an arrangement of general burden-sharing, all member states contribute proportionally, e.g. to the size of their economy, implying a partial transfer of budgetary responsibility to the EU level. This makes sense, since the stability of the European financial system is a public good and of benefit to Europe as a whole. The proportion of general burden-sharing should be kept relatively low however, as it involves cross-border fiscal transfers. This explains why specific burden-sharing arrangements are also needed. Under such arrangements, only the countries confronted with a financial institution in difficulty contribute. Firm-specific arrangements give member states the right incentives to perform their supervisory duties well.

Although a decision on burden-sharing is a necessary condition for a fundamentally new European supervisory structure, we can still make progress without it. In this respect I

envisage grey and white areas. White areas refer to tasks that should be performed at the EU level. These tasks include the licensing and supervision of EU-wide institutions, such as credit rating agencies and platforms for over-the-counter derivatives. It is also conceivable that the Lamfalussy process can be further streamlined by transferring certain decision-making powers to the Authorities. Close to the white areas, there are grey areas, which relate to tasks that can be transferred to the European level, but only if certain requirements are fulfilled. For instance, under the strict requirement that the confidentiality of supervisory information is guaranteed, the supervisory Authorities could be given the competence to send binding information requests to national supervisors.

One last point I would like to make about the new micro-prudential supervisory structure relates to its sectoral design. The group's advice to start with sector-specific Authorities should be reconsidered. The distinctions between financial sectors and products have become blurred, which makes a sector-based supervisory approach less effective. Indeed, the trend in national supervisory structures is towards cross-sectoral supervision. The new European supervisory structure should follow this trend and therewith reduce the risk for supervisory underlap and overlap.

Turning to global perspective

So far I have discussed the challenges and trade-offs involved in transforming the supervisory structure in Europe. While necessary, this is not a sufficient step and more needs to be done. The global nature of the crisis underlines that the financial stability of Europe also depends on the quality of financial supervision outside Europe. Let me briefly raise just two key issues regarding international supervision that warrant further attention, without going into detail.

Scope of supervision

The first issue is the scope of financial supervision, which should be broadened. Key players in the international financial arena, such as credit rating agencies, hedge funds and credit counterparties, are not or only very lightly supervised. Yet, the crisis has demonstrated that their activities could pose system-wide risks, either directly or by triggering excessive risk-taking behaviour by financial institutions. Some form of supervision of these institutions is therefore legitimate. But this task won't be easy as some hurdles are hard to overcome.

The European Commission has taken steps to supervise credit rating agencies in Europe. As I mentioned, it appears logical to license and supervise such agencies at the European level. However, given that credit rating agencies are globally active, a global approach may be even more effective. The proposals of the European Commission constitute a first and necessary step towards global supervision of credit rating agencies in the years to come. With regard to hedge funds, it is beyond dispute that they may under certain circumstances have a destabilizing influence, although they did not trigger the present crisis. As indirect supervision of hedge funds, via their regulated counterparties, has proven less effective in limiting the risks these entities pose, direct and tighter supervision of hedge funds is needed. In this respect, the Commission's recent proposal on a regulatory and supervisory framework for hedge funds and other alternative investment managers can be welcomed. Note however that supervision on hedge funds is complicated by the lack of an encompassing definition of hedge funds and the risk that these entities will move to places with a more hedge fund friendly regime. The first logical step is to register hedge funds, to force them to report on developments in core financial indicators and open positions in excess of certain thresholds and to subject hedge fund managers to a fit and proper test.

The second issue concerns the need to improve the cooperation among supervisors. Under the auspices of the G20 quite a few global colleges of supervisors have been established to foster international cooperation between supervisors. It is expected that more global colleges

for significant cross-border firms will become active in the near future. While colleges are a sensible approach to dealing with the global nature of the financial industry, they have their limitations, especially in a global context. In contrast to EU colleges, global colleges have no legal basis, and this hampers supervisory cooperation and information-sharing. DNB currently chairs two global colleges. In these colleges we provide for several IT tools to encourage as much information-sharing and cooperation as possible, provided that the confidentiality of supervisory information is assured.

Conclusion

Ladies and gentlemen, let me conclude. The crisis has reminded us all too well that a new structure for financial supervision in Europe is urgently needed. In a European context, the proposals of De Larosière group are a good point of departure, though specific amendments are required. At the end of May, the European Commission will present its reaction to the De Larosière group proposals. I will give our present position. To improve macro-prudential supervision, the European Systemic Risk Council should be set up as soon as possible. Open issues about its mandate and institutional design should be resolved. Regarding micro-prudential supervision, I am in favour of more centralised European decision-making, but only if the necessary requirements for such a leap forward are fulfilled. The central issue we need to settle on is burden-sharing at the European level. In a global context, the scope of supervision should be broadened and include all financial systemically-relevant institutions. In line with the G20 declaration, the functioning of colleges of supervisors should be supported.