

Fabrizio Saccomanni: Fact-finding for the examination of the Communication of the European Commission on European financial supervision

Testimony of Mr Fabrizio Saccomanni, Director General of the Bank of Italy, before the Finance Committee of the Chamber of Deputies, Rome, 15 September 2009.

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1. Introduction

The financial crisis has shown the need to strengthen regulation and supervision and to intensify cooperation between national authorities worldwide. In Europe, this effort must be supported by a revision of the institutional arrangements for supervision: markets have become considerably more integrated and an important role is played by large and complex intermediaries with important interests in a number of different countries; financial stability cannot be preserved exclusively by the exercise of powers and responsibilities assigned at the national level.

In the last decade there has been a serious effort to harmonize community legislation. Between 2001 and 2004 the establishment of three so-called “level 3” committees to provide technical support to the Commission and to collaborate with national authorities in the area of banking (CEBS), insurance (CEIOPS) and securities (CESR) has brought about closer cooperation between the authorities and has enhanced the convergence of supervisory practices.

During their first few years the Committees drew up numerous guidelines for the uniform application of community regulations in their respective fields; they introduced their own internal procedures to monitor compliance with common standards in the member states and to resolve disputes between national authorities; they supported the establishment of colleges of supervisors and developed common practices to encourage the efficient organization of controls on cross-border banking groups.

Although substantial, the results achieved are not enough. The *rules* still vary considerably from country to country. The directives contain too many options and national discretions; even in the absence of explicit discretionary powers, transposition into national law has allowed the regulations to be interpreted in many different ways. The result is that the *rulebook* according to which a cross-border group must operate is a collection of national texts that differ significantly from one another even in the harmonized areas. National *supervisory practices* reflect the institutional arrangements and the different traditions of the local authorities. The common rules are filtered through very different approaches to their application. For example, the crisis has shown that harmonized rules on the definition of capital, on securitization and on the consolidation of structured investment vehicles (SIVs) have been applied in very different ways by different countries – in Italy the approach has been rigorous and prudent, but attitudes in other countries are much less restrictive. The *colleges of supervisors*, which bring together the authorities responsible for the supervision of cross-border groups, have not played a pivotal role during the crisis and have basically remained simple centres for exchanging information; only in a few cases has there been a real coordination of the risk assessments and of the joint definitions of the priority areas for supervisory interventions. Discrepancies in the nature and powers of the authorities as well as in the instruments for resolving crises have in practice prevented any real coordination of the actions taken by the single authorities. The tendency to resort to national solutions has been further accentuated by the absence of principles agreed at the European level on the distribution among the member states of the financial costs associated with supporting banks in difficulties.

2. The reform of the European supervisory system

The European Commission has recognized that a supervisory system divided along national lines would find it difficult to prevent and manage crises of a systemic nature. As a result, in October 2008 it mandated a group of high-level independent experts, chaired by Jacques de Larosière, to present some proposals for reform.

In particular, the group was asked to consider how to strengthen European cooperation in monitoring risks to the financial stability of the entire system i.e. *macroprudential* supervision. In effect, the financial crisis has shown that the soundness of individual institutions is not, by itself, sufficient to ensure the stability of the financial system. It is also fundamental to take account of the influence that common risks may have on the system overall; to assess the interactions between the behaviour of single institutions, between the different markets and between finance and the real economy; and to identify the channels through which crises could be propagated.

For years numerous central banks, including the ECB, have performed analyses on financial stability conditions. Often, they have identified risks that subsequently materialized, but they have lacked the instruments for translating their findings into concrete intervention policies.

The mandate of the de Larosière group was to study how best to organize micro-prudential supervision of European financial institutions in order to overcome the limitations of an approach that relies solely on voluntary cooperation among national regulators.

The de Larosière Report proposes a reform resting on two main pillars. The first relates to macro-prudential supervision, which would be entrusted to a new body, the European Systemic Risk Board, or ESRB. The second pillar concerns micro-prudential supervision, to be governed by a European System of Financial Supervisors (ESFS) consisting of three new European authorities in charge of separate areas of financial intermediation (banking, insurance, and securities), the colleges of supervisors and the national supervisory authorities. The Report's recommendations were adopted by the European Commission, which issued a Communication on 27 May this year outlining the main points of the reform and setting out a plan of action to make the new architecture operational by the end of 2010. The Commission's proposals were broadly endorsed by the Ecofin Council of 9 June and by the Council of Heads of State and Government of 19 June. The Commission will put forward its legislative proposals at the end of September, the texts of which should be approved in time to make sure that the new system is up and running in 2010.

In the plan approved by the Council, the ESRB will be assigned to carry out studies on the European financial system in order to issue warnings concerning particular areas of risk and vulnerabilities in the financial structures requiring the authorities' attention. It will then draw up non-binding recommendations for corrective action at European or national level, which will be channelled through the ESFS and the Ecofin Council. Lastly, it will monitor the effective implementation of its recommendations.

As regards organization and functioning, the ESRB will not be an independent legal entity; it will be composed of the governors of the national central banks of the 27 member states, the chairpersons of the three new European Supervisory Authorities, and a representative of the European Commission.

A representative of the national supervisory authority of each member state and the President of the Economic and Financial Committee of the European Union will participate as non-voting observers. The ESRB will be chaired by the governor elected by the members of the General Council of the ECB; the ECB will provide analytical, logistics and administrative support to the ESRB, which will have a Steering Committee comprising the chairperson and vice-chairperson, the governors of two national central banks (one from the euro area and one from a non-euro country), the Commission representative, and the President of the Economic and Financial Committee.

For micro-prudential supervision the reform will institute the European System of Financial Supervisors (ESFS), in which the CEBS, CEIOPS and CESR will be transformed into European Supervisory Authorities (ESAs) with legal personality under Community law. The new system will continue to envisage the decentralization of supervisory powers, which remain with the national authorities and the colleges of supervisors set up for cross-border groups, while a number of important functions will be centralized within the ESAs.

More specifically, the ESAs 1) can issue binding technical standards to ensure that national supervisory authorities follow uniform and consistent approaches and develop a common rulebook applicable to all financial institutions in the European Union; 2) will be empowered to adopt binding resolutions to settle disagreements between national authorities on issues concerning cross-border supervision; 3) will perform tasks of coordination of supervisory activities, including within the colleges of supervisors; 4) will be directly responsible for overseeing the rating agencies; and 5) will set up and manage common databases for information exchanges with the ESRB for purposes of macro-prudential supervision.

As regards organization, the Commission's Communication states that the Board of Supervisors of each ESA should be comprised of high-level representatives of the supervisory authorities of the EU member states. Representatives from the ESRB, the Commission and the relevant supervisory authorities from EEA countries will take part in the Board as observers but would not be able to attend any discussions of confidential matters pertaining to individual institutions. The chairpersons and executive directors of the European Supervisory Authorities should be full-time independent professionals rather than representatives of the national supervisors as was the case with the Level 3 committees. The European Commission has proposed that a Management Board also be set up, where appropriate, which would be composed of a small number of representatives of the national supervisors and a representative of the Commission.

3. Issues in implementing the reform

The institutional framework outlined in the reform proposals boasts several merits. It is important, however, to take an ambitious and unambiguous approach to putting this reform into practice. I would like to consider six aspects that I believe are crucial to success: (1) the ESRB's structure and tools; (2) the independence of the new bodies; (3) the creation of a single rulebook and the establishment of common supervisory approaches; (4) the gathering and sharing of confidential data; (5) the colleges of supervisors; and (6) the legislation and agreements on crisis management.

3.1 Structure, powers and tools of the ESRB

(i) An institutional framework centred on the central banks.

The national central banks are generally assigned a leading role in ensuring national financial stability.

In pursuing the goal of monetary stability the central banks necessarily also consider the aspects relating to financial stability; in the case of the ECB this is recognized in specific provisions of the European Treaty (e.g. Article 105(5)). In view of their institutional competences the NCBs have developed the capabilities, skills and toolkits needed to analyze the stability of the financial system.

The new Board must, from its inception, be firmly anchored to the ECB in order to benefit from the latter's well-established reputation and the direct contribution of the specialist technical and operational know-how needed to monitor the financial stability of the EU area.

Appointing the President of the ECB as chairperson of the ESRB would help to guarantee the adoption of a consistent approach in pursuing monetary stability and safeguarding the stability of the system.

The legal basis for the ESRB will be Article 95 of the Treaty, but it would be advisable to consider appealing also to Article 105(6), under which the ECB can be assigned specific tasks in respect of prudential supervision, so that the institutional nature of the link between it and the ESRB and the modalities of the ECB's involvement in the latter's activities may be established clearly and with the appropriate guarantees.

(ii) *Linkage with micro-prudential supervision.*

Macro-prudential supervision by the ESRB can be effective only if the analyses and assessments of the risks to financial stability serve to orient the priorities of micro-prudential supervision on intermediaries and financial markets. Coordination between the ESRB and the ESAs needs to be very strong even in the analysis phase, so as to ensure a sharing of approaches and speedy and efficient exchange of information.

In particular, risk assessment should be based on the extensive direct involvement of the colleges of supervisors. If the aim is to have the results of macro-prudential analyses used in the supervision of financial groups, the colleges must be able to contribute actively to identifying the main risk factors and the policy options.

On the other hand, the ESRB must be in a position to acquire the micro-prudential information necessary for analysis of the risks, with a special focus on large banks.

The exchange of information between the European Supervisory Authorities and the ESRB should be governed by a protocol of cooperation, so as to ensure observance of the rules on the confidentiality of supervisory data. When highly confidential information is involved, it could be sent in anonymous form.

(iii) *Effective macro-prudential instruments.*

The ESRB's main instrument will be the power to send recommendations to the competent authorities. Separation between the entity that identifies the risks and issues the recommendations and those that control the policy instruments bearing on financial institutions and markets could give rise to confusion in the assignment of responsibilities and to misalignment of incentives. On the one hand, the ESRB's recommendations should be formulated at EU-wide level or possibly refer to specific categories of intermediary or groups of countries but not to individual institutions, in order to avoid confusion of competences with the national authorities that supervise those institutions. On the other hand, the mechanisms for the enforcement of the recommendations must be particularly stringent. The Communication of the Commission envisages that if the national authorities decide not to follow a recommendation or to follow it only in part, they must give a public explanation for their reasons ("act or explain"). This also implies that the recommendations of the ESRB should normally be given adequate publicity. The direct assignment of some instruments to the ESRB could also be considered.

For example, in the international discussion there is agreement on the need to introduce countercyclical prudential instruments that encourage the formation during expansions of buffers to be used in recessions or market crises, when the risks materialize. The ESRB could have a direct role in the design and maintenance of these instruments.

3.2 *Independence, governance and accountability*

(i) *Independence of the ESRB and involvement of the political authorities.*

Anchoring the ESRB to the ECB should provide sufficient guarantees of the institutional independence of the macro-prudential supervisory function.

Indeed, it has been argued that this independence might be excessive, given the responsibilities that governments also have regarding financial stability. However, the institutional arrangement proposed by the Commission strikes an appropriate balance between the different interests.

The involvement of the political authorities is ensured through the participation of the chairman of the EU Economic and Financial Committee in the ESRB as an observer. In addition, the fact that the ESRB submits its recommendations to the Ecofin Council will ensure the governmental involvement and commitment essential to their implementation.

(ii) *Independence of the ESFS.*

By comparison, the safeguards for the independence of the ESFS appear less sturdy. The de Larosière Report, the Communication of the Commission and the Conclusions of the Council underscore that its independence is essential to the success of the reform, but the legal basis for the new authorities will consist solely in Article 95 of the Treaty, which according to the practice followed to date assigns the Commission strong influence over the functioning of European agencies.

The implementing texts must give the ESAs sufficient autonomy in issuing supervisory standards and prevent these from being operationally dependent on the Services of the Commission.

Without amendments to the Treaty, regulatory powers cannot be assigned directly to the ESAs. But the process of approval by the Commission of the standards issued by the ESAs must not actually diminish the authorities' role and their responsibility regarding rules of a more technical nature. In particular, the Commission should not be allowed to approve the texts proposed by the ESAs only in part or to modify them; otherwise, the Commission would become the supervisory standard setter and the ESAs would be relegated to a role of technical assistance.

The Lisbon Treaty provides for two categories of secondary legislation at Community level: delegated regulations and implementing measures. For the latter, which are inherently more technical, there could be a further delegation to the ESAs. The Commission could approve by the "non-opposition" formula, similar to the mechanism used to introduce the accounting standards issued by the International Accounting Standards Board into Community legislation. Under the Treaty, in the cases where the ESAs are considered to have overstepped their bounds in interpreting the delegation or have issued rules inconsistent with the first-order principles, the Commission and the co-legislators, the European Council and Parliament, can revoke the regulations issued by the ESAs and legislate at a higher level – either with primary legislation or with a delegated regulation, assigned to the Commission with the support of high-level committees of member states.

(iii) *Governance of the ESAs.*

The chairpersons and executive directors of the ESAs must be selected through appointment procedures that safeguard their independence, for example with "confirmation" by the European institutions. The Commission should participate in the authorities' decision-making as an observer.

The Commission should be excluded from the management boards and – in contrast with what is proposed in the Commission's Communication – also from the Steering Committee that is to coordinate the actions of the three ESAs. This would also ensure compliance with the requirement of confidentiality in the exchange of supervisory information between the authorities.

The authorities should have an autonomous budget, but, in the light of the important standard-setting tasks delegated by the Commission, provision could be made for substantial resources drawn on the EU or Commission budget.

It will be necessary, lastly, to establish appropriate procedures for the authorities' accountability to the European institutions and to clarify the mechanisms for the enforcement of the agencies' decisions and the procedures for appeals.

3.3 Single rulebook and uniform supervisory approaches

(i) Truly homogeneous supervisory rules and standards in the single market.

The Communication of the Commission and the Conclusions of the Council leave room for highly disparate interpretations of the notion of single rulebook.

In a minimalist reading, the main step could be held to lie in the elimination of options and national discretions from the directives. Instead, it is fundamental to significantly expand the scope of the supervisory rules and standards issued at European level and directly applicable to financial institutions by reducing to a minimum the margins for introducing differences through the process of transposition into national legislation.

Ideally, the set of rules that apply to a financial institution authorized in the European Union should consist largely of directly applicable European rules and only residually of measures adopted at national level in order to take account of the specificities of local markets.

However, there is no blinking the fact that the single rulebook will be drafted starting from a multiplicity of legal orders and supervisory systems, with divergent characteristics.

On financial regulation, in some EU countries a good part of the rules are laid down by sectoral authorities, while in others the national rulebook consists largely in legislation. Italy is somewhere in between: although we have opted for a significant narrowing of the scope of legislation, the regulatory functions are exercised by Italian supervisory authorities under principles and criteria set by law or ministerial decree. As for controls, there are radical differences from country to country in the relative importance of off-site analysis and on-site inspection and in powers of access and verification at intermediaries.

The drafting of the single rulebook will therefore take time. But it is a good thing to specify the stages of the process from the very outset.

(ii) Ample use of binding standards in all the more technical matters.

Going by the Ecofin Council conclusions, the ESAs can lay down standards for the matters to be specified in Community legislation. From the first stage of implementation of the reform, Community legislation could assign the new European authorities the task of setting standards in the areas with the greatest technical content. In banking, for instance, the new authority could be empowered to issue binding standards on the definition of capital, capital requirements, risk concentration, limitation of liquidity risk, prudential reporting, methodologies and procedures for prudential controls, and the practical operation of colleges of supervisors. These are areas that have little impact on the fundamental principles and rules of national law, and in which current divergences often stem from the difficulty of abandoning established practices.

However, there are other sectors in which convergence is less apt to proceed by means of standards laid down by the newly constituted European authorities. Such aspects as the powers of supervisory authorities over market entry and exit, intermediaries' governance and internal controls, and sanctions affect each nation's normative and institutional arrangements more substantially and so require specific national rules for implementation. These parts of the rulebook may well continue to be governed at Community level by the traditional instrument of the directive, albeit one for maximum harmonization.

(iii) Convergence on a high level of prudential rigour in standards and application.

Finally, turning to the substance of the single rulebook, it is important that convergence not be pursued at the expense of the efficacy of rules and controls.

We must prevent the difficulties of reaching agreement among such different approaches from resulting in the adoption of accommodating standards and supervisory practices – a sort of lowest common denominator.

Rather, the European rulebook should look to the rules and supervisory models of the countries whose financial systems have proven most robust – those least exposed to the causes and consequences of the crisis, thanks to strict and particularly risk-sensitive supervisory practices. In our view, this crisis shows that the Italian supervisory model can provide a useful point of reference for the process of convergence.

It will be just as important to develop strict, common approaches to the enforcement of the European standards.

The vulnerability of the European financial system is due in part to the fact that in some countries the harmonized rules have been applied less strictly, in keeping with a “light touch” supervisory model too fearful of interfering with intermediaries’ decisions.

The ESAs must clearly define the procedures for applying the rulebook and verify that the national authorities ensure high quality supervision. Financial innovations and new market practices must be brought before a European forum to decide on common supervisory policies. This is the only way to prevent some countries from adopting a more accommodating stance so as to give their own intermediaries a competitive edge, at the expense of area-wide financial stability.

3.4 Collection and exchange of information

The ESAs will play a major role in determining the supervisory data that are to be shared and organizing their collection and aggregation in central databases. The main users will be the national supervisory authorities, above all for evaluating the risks of cross-border groups within the colleges of supervisors. Accordingly, in this area the ESAs should involve the colleges closely, taking their cue from the structures developed in the last few years.

The information centralized in databases operated by ESAs should enable supervisors to conduct effective peer group analyses.

In addition to basic supervisory data, it could be most useful for supervisors to share the results of stress tests on the main banking groups and their consequent risk assessments.

The best way to achieve this is to have the ESAs themselves conduct the stress tests at European level, using common scenarios and methodologies and providing for mechanisms to determine the sources of differences between single financial groups. To make this possible, access to the data must be restricted to a small group of supervisors and strict rules must be enacted to safeguard the confidentiality of such sensitive data.

3.5 Colleges of supervisors

With the reform, the ESAs are given a central role in coordinating the activities of the colleges of supervisors. The first step should be setting standards for the functioning of the colleges based on today’s best practices, to enhance consistency within the Union. In this regard, the two colleges instituted by Banca d’Italia for the top two Italian banking groups represent an especially positive experience. Rules are already in course of application establishing the legal basis for the colleges, broadening their tasks – including in crisis situations – and creating joint decision-making processes for supervisory controls, which may eventually result in specific capital requirements for the groups and for their individual components.

So far, the colleges have worked well where the law is sufficiently stringent in defining their tasks, as for instance in the validation of the intermediaries' internal risk measurement models. The results have been less satisfactory where the functioning of colleges is based on voluntary commitments.

To achieve a truly integrated system of controls on cross-border groups, in which the colleges can act as promptly and as effectively as national supervisors now do, it would be necessary to create the conditions for expanding the scope for concerted decision-making by the supervisory authorities. Consideration should be given to enacting Community legislation on banking groups patterned after the Italian law, which recognizes the coordinating role of the parent company and institutes a clear framework for the proper attribution of rights and responsibilities to all the components of the group. The parent company could be made responsible for interacting with the college of supervisors and making sure that the latter's indications are complied with by all group members.

3.6 Legislation and agreements on the management of crises

In line with the recommendations of the de Larosière Report, the Ecofin Council has charged the Commission to reinforce the so-called "infrastructure legislation" referring to the procedures for the prevention and resolution of crises of cross-border groups. The Economic and Financial Committee has been asked to develop proposals to improve the cooperation mechanisms for managing crises at these intermediaries.

(i) The instruments for managing crises.

In the first place significantly increased harmonization of legislation on the instruments for managing crises is necessary.

In fact the large disparities between member states with regard to national authorities' powers and responsibilities in early interventions and the procedures for resolving crises prevent the coordinated management of interventions involving cross-border groups.

The Commission has undertaken to present proposals for European legislation in this field shortly. The procedures laid down in the Italian legislation on the management of banking crises, which include preventive measures, have proved effective and could be a useful model for guiding the work carried out at the European level. The possibility of introducing a common procedure for the management of the crises of cross-border banking groups should also be weighed.

If this were not feasible, at least the application of the Directive on the winding up of credit institutions could be extended to the subsidiaries of foreign banks, as a first step towards a greater degree of harmonization in this field.

(ii) The removal of obstacles to the transfer of assets within the European Union.

Progress is needed in the harmonization of company and bankruptcy law to remove the obstacles that prevent the transfer of assets and liquidity between the various components of cross-border banking groups. The possibility of ring-fencing assets held in a country leads in fact to solutions that are rational from the standpoint of individual member states but inefficient in terms of enhancing the value of the group's assets; in some cases ring-fencing may even accelerate insolvency and complicate the management of the crisis.

(iii) Deposit insurance schemes.

The Commission is also working to reduce the disparities still present in the working of deposit insurance schemes. The recent revision of the directive raised the levels of coverage and shortened reimbursement times, but it did not reduce the wide margins of discretion member states enjoy regarding the funding of the schemes, or the conditions for and the characteristics of the interventions. In promoting a greater degree of harmonization of these

aspects, it should also be possible to consider a common deposit guarantee scheme at European level, which could interact with national deposit protection schemes and make an invaluable contribution to the coordinated intervention of national authorities in the event of crises of cross-border groups.

(iv) *Cooperation agreements and sharing the burden of crises.*

Lastly, it appears desirable to develop mechanisms for coordinated intervention in crises to minimize the impact on markets and, ultimately, on taxpayers. In line with the indications contained in the Memorandum of Understanding signed by the ministries of finance, central banks and supervisory authorities of the European Union in 2008, the Economic and Financial Committee is preparing general recommendations for agreements under which each national authority undertakes a clear commitment with regard to the support it could provide in the event of the crisis of a cross-border group.

The details of these burden-sharing agreements should be left to the structures for coordination among supervisory authorities, central banks and finance ministries (cross-border stability groups) that will be set up for each banking group.

Conclusions

In the coming months it will be necessary to monitor the implementation of the reform closely and make sure that an ambitious and rigorous approach is adopted, as indicated by the Minister for the Economy and Finance in the note accompanying the transmission to Parliament of Consob's Annual Report. Ambiguous solutions risk creating confusion of roles and conflicts between authorities; compromises that in reality maintain the status quo as regards national authorities' powers or encourage lax controls do not solve the problems that the crisis has brought out.

In my remarks I have tried to outline the points that can determine the success of the reform:

- in the first place it is necessary to provide the European Systemic Risk Board (ESRB) with effective operational instruments and a solid institutional basis, possibly by activating Article 105(6) of the Treaty, which provides for the ECB to be entrusted with specific supervisory tasks;
- then it is necessary to guarantee the independence of the new European authorities: the political authorities can be involved as observers in the process of macroprudential supervision and contribute to the implementation of the ESRB's recommendations; the European Securities Authorities (ESAs) will have to be exclusively responsible for defining the technical standards of supervision for the European Union, with appropriate accountability mechanisms;
- it is also necessary to take determined steps towards effectively uniform rules, with greater recourse to European regulations instead of directives and with the technical standards of the new authorities directly applicable throughout the entire single market without their having to be transposed. Moreover, the uniformity of the rules will have to be accompanied by equal degrees of rigour in the supervisory approaches to implementing controls and adopting corrective measures;
- confidentiality mechanisms and rules will have to be introduced to ensure that confidential information is shared to a much greater extent than today, thereby facilitating the creation of common databases;
- colleges of supervisors must be put in a position to function with the same efficacy in relation to cross-border groups as national supervisors; this must be ensured through new Community legislation on banking groups;

- new legislation must be adopted on crisis management procedures and deposit insurance schemes, together with agreements among authorities with clear commitments on support for specific cross-border groups.

I hope these suggestions may be of help to the Committee in defining its stance with regard to the proposals of the Commission and the recommendations of the Council and in providing indications to the Government on the position to take in this important institutional reorganization.