Lessons of the Crisis for EU Financial Supervisory Policy

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It is a pleasure to be able to address you here today, as part of this interesting and timely debate here in Brussels. The Fund has studied the recent recommendations of the De Larosière group with great interest. If introduced, these recommendations will represent a number of important advances.

- Establishment of a European Systemic Risk Council (ESRC), chaired by the ECB, and comprised of national central banks and CEBS can provide a much needed bridge between macroprudential analysis and supervisory action.
- A strong European System of Financial Supervision (ESFS) is a useful step that should provide momentum towards achieving the twin goals of a level playing field and strengthened oversight of cross-border institutions.
- Harmonized and pre-funded deposit insurance schemes, alongside greater clarity on burden sharing, can contribute to a much needed strengthening of the national and European arrangements for the resolution of cross-border financial institutions.

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But while the direction of these proposals is undoubtedly right, the enormity of the current crisis and the challenges it highlighted in the areas of macroprudential policies, microprudential policies, as well as resolution, leads me to ask whether the overall framework could be strengthened further. The following three questions arise.

- With respect to cooperation between home and host country supervisors, will the new microprudential authorities be endowed with sufficiently strong powers to ensure strong oversight of large and complex cross-border institutions; and credible enough to offer binding mediation?
- What additional tools may be needed to ensure effective resolution of substantial deposit takers and cross-border groups?
- Will the new ESRC generate sufficient traction for macroprudential analysis and a sufficiently strong imprint on microprudential policies?

I. MICROPRUDENTIAL SUPERVISION AND THE ROLE OF THE EU.

I am planning to return to all three issues. But let me focus first on a fundamental difficulty. It is that on the one hand, cross-border integration of European financial markets is desirable. But that at the same time, financial supervision remains fundamentally a national responsibility.

It is worth asking: why is this so? There is a British proverb (coined by the London "Daily News" in 1895) that says "He who pays the piper chooses the tune." That is, there are good reasons to align supervisory authority with fiscal responsibility. After all, those who pay for resolution have good incentives to ensure effective supervision—I think Charles Goodhart can be credited for making this observation first.

Ultimately, resolving this tension requires moving towards some form of European fund that can be used to safeguard financial stability, for example in the resolution of cross-border groups.

Let me sketch out one way in which this could be achieved that may be feasible, and that could build on the call to establish pre-funded and harmonized deposit insurance schemes across the European Union.

Alongside domestic schemes, a new **European Deposit Insurance Fund (EDIF)** could be set up to insure deposits issued by branches or subsidiaries outside the home country. The scheme should be pre-funded by the industry for good and well-known reasons and could operate alongside domestic pre-funded insurance schemes which would continue to insure deposits issued in the home country.

The scheme would need to be backed up by the fiscal authorities of each and every member state, perhaps according to a pre-specified formula. The detail would need to be worked out but the formula might take in factors such as the total value of deposits in each country, the share of deposits issued by foreign banks and the share of deposits of domestic institutions that are issued cross-border.

Importantly, such fiscal backing would provide incentives toward the collective responsibility embedded in the October 2007 ECOFIN crisis management principles. It would generate an interest at the national level in ensuring proper oversight of cross-border institutions across the European Union. This would bring a number of benefits.

- It would increase the legitimacy of and national backing for the new European microprudential authorities, in which the EDIF could be represented.

- In this way, it could create much needed momentum towards strengthening the oversight of large cross-border groups.

- It would also give additional legitimacy to a role of the new European authorities in mediating between home and host country supervisors.

In sum, it would be an important step in reconciling a role of the European authorities in microprudential supervision with the principle that supervision ought to be aligned with fiscal responsibility. This would strengthen the European authorities while at the same time increasing the level of acceptance by national authorities.

II. Crisis Resolution

The crisis has underlined that big challenges surround the resolution of financial institutions, at both the international and national levels. As far as cross-border resolution in the EU is concerned, the exchange of supervisory information between home and host supervisors needs to be improved and incentives to withhold information removed. Greater clarity on the principles that govern the sharing of fiscal burdens is desirable. And there is a question how the application of these principles can be made more binding on the negotiating parties in a crisis situation.

However, we also need to think about ways to reduce the size of fiscal burdens, i.e., to contain the damage inflicted by bank failures. This can be achieved through early remedial action and the application of **special resolution regimes** for financial institutions. The crisis has revealed the absence or the limited scope of special resolution regimes in a number of cases. The absence of a robust regime has been felt keenly in the United Kingdom in the case of Northern Rock, as well as in Germany, in the cases of Hypo Real Estate and IKB. The limited scope of the bank resolution framework in the United States has led to the disorderly bankruptcy of Lehman and contributed to the global systemic impact of its failure. Finally, the absence of a special resolution framework in Belgium complicated the handling of the

Fortis case, as the government was forced to obtain the approval of shareholders for its resolution strategy.

Special resolution regimes afford a number of tools to the authorities to effect an orderly resolution at an early stage. These tools typically involve the rapid (partial) transfer of assets and liabilities to a new or existing institution. This preserves key banking functions and at the same time ensures that losses are borne by shareholders. The presence of a special resolution regime can thus at the same time reduce the impact of a failure on financial markets, increase the share of losses borne by shareholders and reduce fiscal outlays. All of these characteristics are highly desirable *ex post*. They can also reduce expectations of fiscal support, correct distorted incentives of financial institutions and increase the force of market discipline *ex ante*. In this way special resolution regimes have the potential to make a substantial contribution to financial stability both in normal times and in crisis times.

In a European context, but also more broadly, it is desirable to ensure consistency of resolution frameworks across countries. This could be achieved through the development at the European level of common principles that should guide the design of the regimes. Such common principles can draw on emerging best practice. It can build in particular on the experience in the United States, where a special resolution framework has helped the FDIC resolve bank failures since 1991, and those in other countries, such as the United Kingdom, where changes in the legal regime were —or are being —set in train in response to the crisis experience. In this regard, a forthcoming White Paper by the European Commission is potentially of great significance.

To be sure, a number of European countries may face obstacles to the introduction of such frameworks. For example, a special resolution framework affects the rights of shareholder, relative to the existing insolvency framework. But the crisis experience now provides an opportunity to push through the required reforms. Moreover, a further potential deepening of the crisis that may well lie ahead. This should reinforce the urgency of making rapid progress across the European Union.

III. Macro- and Macroprudential Policies

Let me turn to my third and final issue. Will the new structure be able to ensure that macro-systemic analysis conducted under the auspices of the ESRC finds sufficient traction, including by influencing prudential rules (such as capital requirements) and the application of microprudential policies more generally? The report of the De Larosière group discusses a number of safeguards in this regard. Importantly, it envisages the participation of the ESFS Authorities in the ESRC.

The report also moots a potential revision of the overall European framework after a number of years, that could move the structure closer to a **twin-peaks approach**, with a European prudential and systemic risk authority on the one hand and a conduct of business authority, that would operate across all sectors (banking insurance and securities), on the other. At the national level, the former authority is usually closely linked to or part of the central bank.

Such a twin peaks structure, which was introduced in the Netherlands in 2002, recognizes more explicitly the contribution prudential policies can make in mitigating macro-systemic risk, that can arise from an overexposure of financial institutions to aggregate risks as well as from the failure of large and interconnected institutions. At the national level, it finally recognizes the contribution central banks can make in mitigating both macro- and micro-systemic risk, by assigning the role of prudential and systemic risk regulator to the central bank. Our experience in the Netherlands shows that there are important benefits to having all information at the same time, around the same table.

This begs the question, what stops the EU from introducing a twin-peaks model right away? One consideration is that national financial stability frameworks differ across the European Union with regard to the role of the central bank and its relationship to potentially separate supervisory agencies. In some countries, such as the Netherland, Spain, France, Italy, and the Czech Republic, the central bank remains the prudential supervisor of banks and large complex institutions. By contrast, in a number of other countries, such as the United Kingdom, Belgium, Sweden and Denmark, an integrated supervisory agency is entrusted with both conduct-of business and microprudential regulation and the central bank is not typically given a mandate or the operational capacity to influence prudential policies as conducted by the integrated supervisor.

The crisis experience has called into question the wisdom of removing the central bank' influence on prudential policies along both the macro- and the micro-systemic dimensions. For instance, the Group of Thirty has recently called for giving central banks a role in the supervision of large and complex financial institutions. In response, we may therefore see a growing trend towards a stronger role of central banks in financial stability at the national level. In some cases, this might be effected by enhanced mechanisms for interagency coordination and operational linkages between central banks and supervisory agencies. With time, such a trend might increase the attractiveness of a twin-peaks structure at the European level, as well.