

European Systemic Risk Board, the European Central Bank, and the ESAs: Managing the triangular

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Lessons from the crisis

- Institutions and market structures
 - Power of financial contagion in integrated EU and global financial markets
- Policy analysis
 - Market-based financial regulatory models do not adequately monitor and control systemic risks
- Policy implementation
 - Outdated regulation can exacerbate externalities
 - Failure in EU single market regulation to give sufficient attention to safety and soundness issues

Global reform agenda

- Global consensus on need for more effective, better coordinated macro- and micro-prudential regulation and supervision
- Oversight of systemic risk has to be globally co-ordinated
- Systemic risk oversight bodies: international, regional, national
 - Global: Financial Stability Board (FSB)
 - EU: European Systemic Risk Board (ESRB)
 - UK: Council for Financial Stability
 - USA: Systemic Risk Council (Obama)/single federal prudential regulator (Dodd)
 - Switzerland: systemic risk oversight committee (FINMA and Swiss National Bank)
 - France: Financial Regulation and Systemic Risk Council

“Soft” institutions as monitors of systemic risk: the challenges

- Can “advisory” bodies actually strengthen and reinforce the system?
- Or are they merely “symbolic”?
 - ESRB
 - "toothless talking shop, which will duplicate activities already undertaken by other national and international institutions" (*UK House of Commons Treasury Committee*)
- Our thesis: Lack of formal power not an insuperable barrier to ESRB credibility and authority
- Supported by review of operation of soft laws and institutions in international financial regulation (especially FSB)
- But much depends on
 - Legal framework
 - Policy choices and practical implementation
 - Relations with the EU institutions, new micro-prudential EU supervisory authorities, and MS bodies

Softness in international financial regulation (in brief)

- International financial regulation is a soft law framework– non-binding standards, guidelines, interpretations etc
- System developed and overseen by soft bodies
- “Hardening” of soft law (implementation and enforcement)
 - Adoption into domestic/regional legal order
 - Benchmarks in international assessments (IMF/World Bank)
 - Market/reputational sanctions: cost of capital; signalling
 - Defensive self-regulation
- Benefits: open-textured - can be adapted to fit local circumstances; allows for experimentation/made by flexible public-private sector groups with appropriate expertise
- Drawbacks – “junk” law/made by unrepresentative bodies/opaque/unaccountable/“rent-seeking” behaviour/capture
- Checks and balances – global administrative law
- “Simply another tool in the professional lawyer’s armoury” (*Boyle*)

The Financial Stability Board: a soft institution with hard-edged power (in brief)

- FSB (global systemic risk)/ESRB (EU systemic risk)
- FSB – G20 mandate to promote global financial stability
- Members: developed countries and large developing countries
 - national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance) international financial institutions
 - standard-setting bodies
 - committees of central bank experts
- FSB mandate includes
 - Assessing vulnerabilities, and identifying and overseeing action needed to address them;
 - Collaborating with the IMF to conduct early warning exercises
- FSB soft institutional structure and no binding powers
- Flexibility/speed evident in response to crisis in 2009
- Impact?
 - Obligations on members
 - FSB members produce almost 90% of world GDP: leading by example
 - Peer reviews
 - Implementation & follow up
 - Transparency
 - “Naming and shaming”
- Accountability and legitimacy concerns

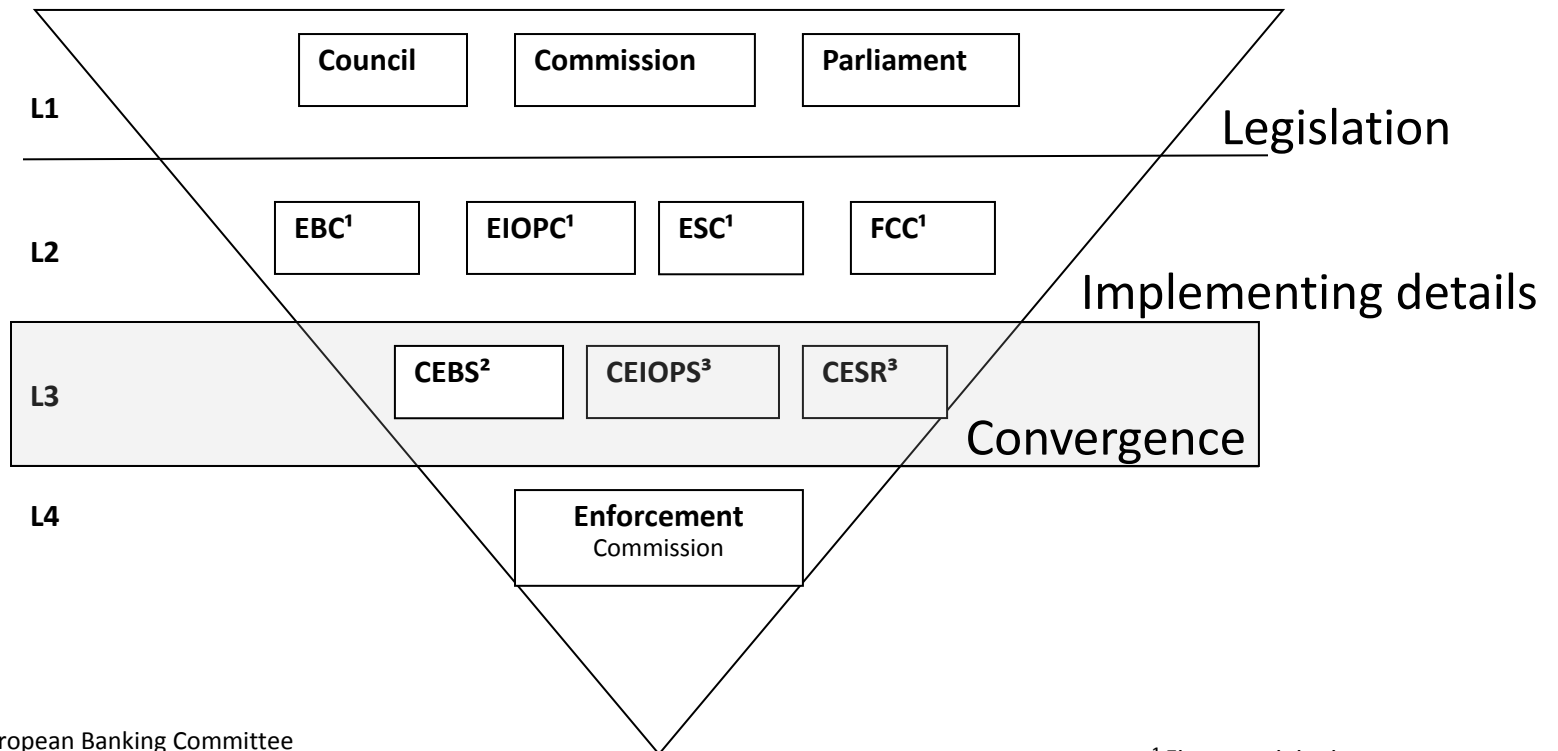
EU soft law: some general issues

- EU legal order – not a system of international law (important qualification re applying lessons from international level experience)
- ESRB – not a “mini” FSB – sits within a different legal/institutional framework
- Soft law in EU law
 - “rules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain (indirect) legal effects, and that are aimed at and may produce practical effects” (*Senden*)
- Controversies
 - legitimacy of “surrogate” law
 - circumvention the properly competent legislative bodies
 - Flouting principles of democracy, rule of law, subsidiarity, proportionality
 - Treaty basis
 - Remote “superbureaucracy” prone to industry capture (*European Parliament*)
- Acceptance of use with caution
 - “the admixture of formal and informal law is a common feature of any legal order” (*Craig and de Búrca*)

EU soft law and financial regulation

- Currently in use
 - Soft law and soft methods in the non-binding guidance issued by the Lamfalussy committees (CESR, CEBS & CEIOPS)
 - ECB non-binding recommendations
 - ESCB opinions and recommendations
 - “Soft” enforcement: peer reviews, mediation, high level principles, risk-based processes
- New arrangements for oversight of systemic risk
 - ESRB – an “unprecedented” reputational body with no binding powers
 - Key element of framework for macro-and micro-prudential supervision
 - But presents legal, political, practical challenges

The EU Lamfalussy structure



EBC = European Banking Committee
EIOPC = European Insurance and Occupational Pensions Committee
ESC = European Securities Committee
FCC = Financial Conglomerates Committee
CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors
CESR = Committee of European Securities Regulators

¹ Finance ministries
² Supervisors and Central Banks
³ Supervisors

Shortcomings of the Lamfalussy system

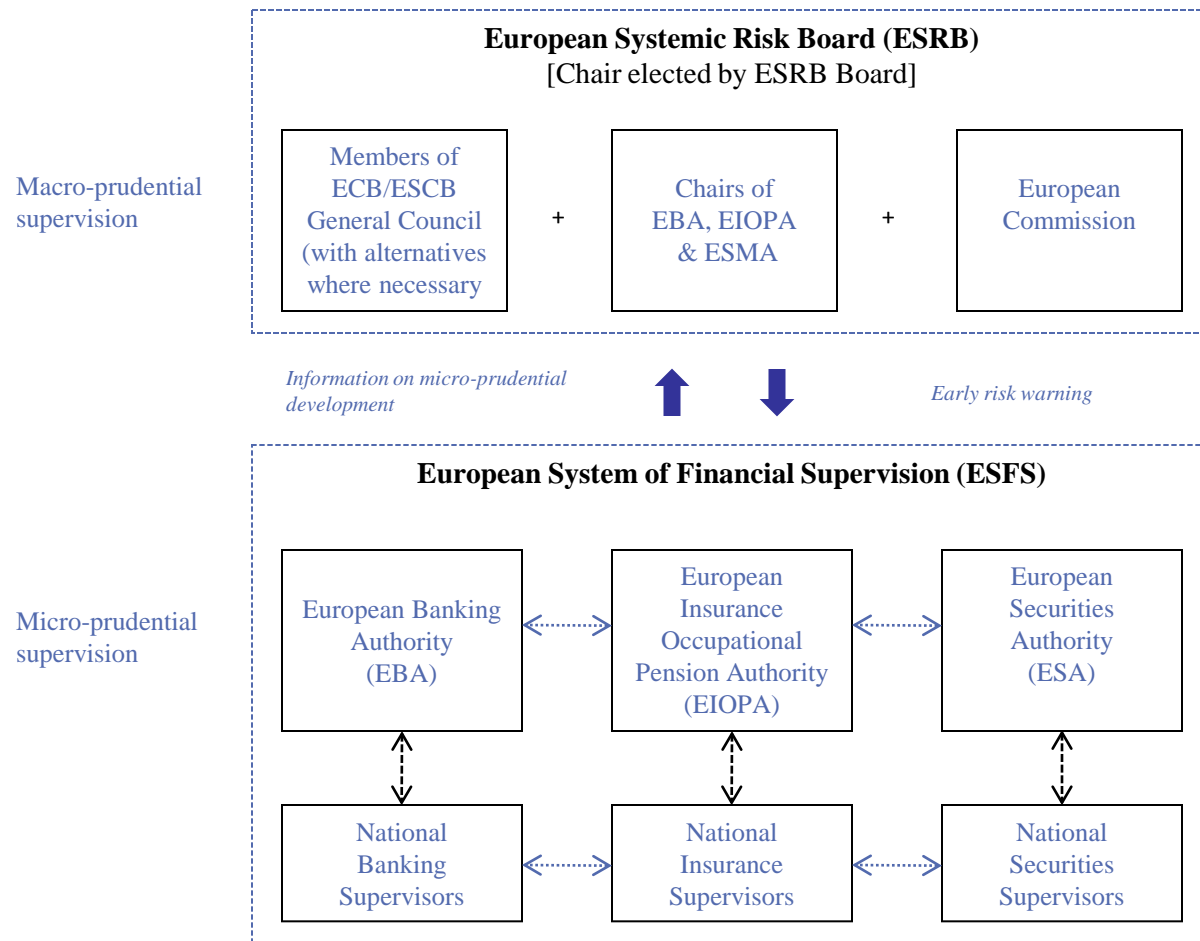
- Patchy progress by L3 committees in promoting consistent implementation of Community legislation/enhancement of convergence in EU supervisory practices
- Weak link (IMF): no clear framework with respect to the oversight of the cross-border operations of financial groups in EU
- Refinements – eg MoUs, CEBS/BSC Joint Task Force on Crisis Management; strengthening of L3 committees
- *de Larosière Report*

The future of EU financial architecture

From De Larosière Report to the EU Commission proposed Regulations.

- On the micro-prudential side: the European System of Financial Supervisors (ESFS).
 - It will consist in the current Level 3 Committees of supervisors, which will be transformed into new European Supervisory Authorities (ESAs) responsible for banking, insurance and securities respectively.
- On the macroprudential side, a European Systemic Risk Board (ESRB) will be established.
 - It will be composed of EU central bank governors, including the ECB President, the chairpersons of the ESAs, a representative the European Commission, as well as representatives of national supervisory authorities and the Chair of the EFC (the latter two categories without voting rights).

The future of EU financial supervision



The European Systemic Risk Board: organizational structure

- General Board, Steering Committee and Secretariat; supported by an Advisory Technical Committee
- General Board: decision making body of the ESRB; 61 voting & non-voting members
- Voting members
 - governors of national central banks
 - president and the vice-president of ECB
 - European Commission representative
 - Chairpersons of the three ESAs
- One-member, one-vote; simple majority (2/3 for public warning /recommendation)
- Chair/vice-chair
- Non-voting members
 - MS competent authorities
 - president of the Economic and Financial Committee
- Duty of impartiality

- Too big? Too dominated by central bankers? Steering committee and non-eurozone representation?

ESRB: legal status, delegated powers and Treaty basis: the issues outlined

- Regulation under TFEU, article 114 as a body without legal personality and with no binding powers (“soft”)
- Flexible
 - “common innovative framework for financial supervision” ... "wide scope and the sensitivity of its missions" (*European Commission*)
- Can a body without legal personality/binding powers have impact?
 - FSB comparison
 - If not taken seriously, system fundamentally flawed
- But is a “powerful” informal body compatible with EU law/ what are the implications for institutional relations and governance?

The ESRB as a informal body without precedent

- ESRB/ECB: will lack of legal personality make it harder to maintain an appropriate distance?
- Will ESRB lack of legal personality limit its ability to obtain confidential information from ESAs, MSs, and firms?
- ESRB structure as an infringement of the “spirit” behind strict limits on the powers that can be conferred on regulatory agencies in the current Community legal order?
- Governance and accountability
 - Adequacy of an annual reporting requirement?
 - Significance of duty to seek advice from private-sector stakeholders “where appropriate”?

Legal basis

- Article 114 as the legal basis for the establishment of bodies that are vested with responsibilities for contributing to the harmonisation process and facilitating uniform implementation by MSs (Case C-66/04, C-217/04)
 - Actually and objectively apparent from the legal act creating the body in question that its purpose is to improve the conditions for the establishment and functioning of the internal market
 - Tasks conferred on such a body must be closely linked to the subject-matter of the relevant harmonizing legislation

Legal basis and ESRB mission

- “The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Community in order to prevent or mitigate systemic risks within the financial system, so as to avoid episodes of widespread financial distress, contribute to a smooth functioning of the Internal Market and ensure a sustainable contribution of the financial sector to economic growth” (ESRB Regulation, art 3)
- Tasks conferred on the ESRB must be undertaken for the purpose of discharging overarching responsibilities with respect to macro-prudential oversight and containment of systemic risk
- “Macro-prudential”/”systemic risk” and existing EU law – can the link between subject-matter of the harmonizing laws and the tasks delegated to the ESRB be established?
- Stability and soundness as pre-requisites for the smooth operation of any financial market
- ESRB within the room for innovation in harmonization techniques that article 114 provides

ESRB: a mandate with an uncertain scope?

- “Systemic risk” – merits of an express legal definition in EU law?
- G10 (2001)
 - the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy. Systemic risk events can be sudden and unexpected, or the likelihood of their occurrence can build up through time in the absence of appropriate policy responses. The adverse real economic effects from systemic problems are generally seen as arising from disruptions to the payment system, to credit flows, and from the destruction of asset values.’
- Currently no generally accepted legal definition
- Nor do economists agree on its definition, how to measure it, or on the regulatory measures that are necessary to combat it
- Risks inherent in attempting to define it in law – too restrictive given its capacity to evolve and emerge in new forms/too open-textured to be justiciable
- But important for the ESRB itself to concretise its role

ESRB: building credibility – challenges

- Central bankers not legitimate politically for making decisions that involve important trade-offs between political and economic objectives and that such decisions should be left with finance ministries and other elected officials (*Buiter*)
- Lack of diversity/unwieldy size (*Sibert*)
- Technical competence re systemic risk (*Treasury Committee/Buiter*)
- And also re interpretation of data at both the micro and macro-levels (*Treasury Committee/Danielsson*)
- Price stability and financial stability objectives pull in opposite directions (*Buiter*)
- Liberalised and integrated financial markets → increase financial fragility (*Dungey & Tambakis*)

The ESRB: subsidiarity and proportionality

- “Effective macro-prudential oversight of the Community financial system cannot be sufficiently achieved by the Member States because of the integration of the European financial markets” (ESRB Regulation, rec 20)
- Justified in cost-benefit terms? But query justiciability
- Subsidiarity as a basis for managing relations between ESRB and MS systemic risk oversight bodies

ESRB warnings and recommendations: hard-edged soft power

- Will the ESRB establish a reputation for competence by “getting it right”?
Reputation
- Will its warnings be taken seriously? *Credibility*
- Compliance pull: reputation but strengthened by availability of hard enforcement powers in system of which ESRB is a part; this has strengths but also potential weaknesses
- Warnings/recommendations to Community, MSs, ESAs, MS CAs (but not banks/financial firms)
- Comply or explain; reference to Council/ESA
- Publication of warnings/recommendations
- ESA obliged to co-operate, ensure follow up and take the “utmost account” of ESRB pronouncements
- MS CA liaison with ESA
- Warning → emergency situation → ESA decision

ESRB warnings and recommendations: hard-edged soft power (contd)

- “It is true that the ESRB will have influence rather than power, and that its effectiveness will, in the long run, depend on its credibility, but it would be a mistake to underestimate the extent of the ESRB’s potential to trigger real effects” (*Treasury Committee*)
- Reputational damage by association
 - Important for ESRB that the ESAs be established on secure legal footing and political sensitivities (fiscal sovereignty) smoothed
 - Repercussions for ESRB where associated with an action by a supervisor that is the subject of a legal challenge

The new supervisory model

‘Central to this supervisory model is the presumption that regulators cannot rely on the judgment of the firms they supervise, and must take their own view formed from their own analysis about significant issues which affect the safety and soundness of the firm. . . . Furthermore, where that judgment differs from the firm’s management, the regulator must act.’

Hector Sants, CEO of the UK Financial Services Authority

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