



IV SPECIAL FEATURES

A TOWARDS THE EUROPEAN SYSTEMIC RISK BOARD

The financial crisis has raised questions about the effectiveness of the current supervisory architecture. As a result, policy recommendations for regulatory reform have emerged at the European and global level which aim at enhancing the tools and structures devoted to macro-prudential oversight, as well as at ensuring an effective interplay with the monitoring of individual financial institutions. The overall objective of these policy actions is to strengthen the resilience and robustness of the financial system and thus enhance financial stability.

Against this background, this special feature describes the framework being proposed for macro-prudential oversight in the EU and is structured as follows: first, it describes the decisions and actions taken at the international and EU level to strengthen macro-prudential supervision. Second, it elaborates on the envisaged framework for contributing to the safeguarding of financial stability at the EU level. Finally, the processes of the proposed macro-prudential supervisory framework, as well as the challenges for the proposed framework to work effectively, are analysed.

INTRODUCTION

A fundamental lesson from the current crisis is the need to reinforce the macro-prudential orientation of financial regulation and supervision, as well as to ensure an effective interplay with the monitoring of individual financial institutions.

Macro-prudential analysis focuses on the financial system as a whole and devotes particular attention to the costs of financial instability to the real economy. It covers the threats to financial stability that stem from common shocks affecting a large part of (or all) institutions, as well as contagion of individual problems, to the rest of the system, as opposed to micro-prudential analysis that focuses on financial institutions individually, including their

liquidity, capital strength and risk management. The macro-prudential approach thus recognises that risks to the financial system may stem from the collective behaviour of financial institutions, from their interaction in financial markets and from the close links between the financial system and the overall economy.

Macro-prudential oversight is devoted to the monitoring, assessment and mitigation of systemic risk, which can originate from sources that are both endogenous and exogenous to the financial system, and is characterised by both cross-sectional and time-related dimensions.¹ The cross-sectional dimension concerns how risks are correlated across financial institutions, markets and infrastructures at a given point in time (e.g. the phenomenon of contagion), while the time-related dimension concerns how systemic risk evolves over time (e.g. the unravelling of imbalances that build up over time).

This perspective is not new and was recognised well before the crisis.² Many of the factors intensifying the current crisis had been anticipated in financial stability assessments, notably those conveyed in financial stability reports issued by central banks and supervisors. However, these assessments were often not effective in triggering concrete policy and regulatory responses. Hence the concern that the new framework for contributing to the safeguarding of financial stability should better ensure the translation of financial stability assessments into policy and regulatory responses by the competent authorities, so that risk warnings and, in particular, recommendations are effectively translated into follow-up actions.

- 1 See J. Fell and G. Schinasi, "Assessing Financial Stability: Exploring the Boundaries of Analysis", *National Institute Economic Review*, No 192, April 2005, for a discussion of the identification of risks for financial stability assessments, and Special Feature B "The concept of systemic risk" in this FSR for an in-depth discussion of the concept of systemic risk, as well as relevant theoretical and empirical research in this field.
- 2 See A. Crockett, "Marrying the micro- and macro-prudential dimensions of financial stability", *BIS Review* 76/2000, September 2000; and C. Borio, "Towards a macro-prudential framework for financial supervision and regulation?", *CESifo Economic Studies*, Vol. 49, No 2/2003, 2003.

STRENGTHENING THE MACRO-PRUDENTIAL APPROACH TO OVERSIGHT AND REGULATION

Against this background, as reflected in the policy recommendations for regulatory and supervisory reform emerging from European and global fora, there is a consensus to move in direction of enhancing the tools and structures devoted to macro-prudential oversight and ensuring an effective interplay with micro-prudential supervision. This consensus has resulted in various actions being taken at the international and EU level (see also Box A.1 for the measures considered in the United States).

At the international level, a clearer framework is emerging for identifying risks to financial stability, as well as for designing and enforcing minimum regulatory standards. In this context, two key international bodies have an important role to fulfil, namely the International Monetary Fund (IMF), with its focus on surveillance, and the recently established Financial Stability Board (FSB, which replaced the Financial Stability Forum), focusing on policy coordination.³ More specifically, the G20 called on the FSB to develop macro-prudential tools in cooperation with the Bank for International Settlements (BIS) so as to identify and take account of macro-prudential risks across the financial system and limit the build-up of systemic risk for regulated entities. The FSB has also been asked to cooperate with the IMF on the conduct of early warning exercises.

In the EU, in November 2008, the European Commission commissioned a High-Level Group chaired by Jacques de Larosière to provide advice on the future of European financial regulation and supervision. The High-Level Group on Financial Supervision in the EU published its report in February 2009 (the “de Larosière Report”).⁴

Based on the recommendations made in the de Larosière Report and on the subsequent Commission Communication on Financial Supervision of 27 May 2009, the ECOFIN Council of 9 June 2009 and the European Council of 17 and 18 June 2009 decided on the establishment of a new EU supervisory

architecture based on a two-pillar structure comprising the European Systemic Risk Board (ESRB), responsible for macro-prudential oversight, and the European System of Financial Supervisors (ESFS), focusing on micro-prudential supervision. The latter will consist of a network comprising three new European Supervisory Authorities (ESAs) for each financial sector and national supervisors.⁵ On 23 September 2009, the European Commission adopted: (1) a proposal for a Regulation of the European Parliament and of the Council on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board; and (2) a proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board.⁶ The Commission’s proposals will have to be adopted by both the European Parliament and the Council or the Council only, depending on the applicable legislative procedure. The ECOFIN Council of 20 October 2009 agreed in substance on these proposals (which are now being considered by the European Parliament as well). At its meeting on 29 and 30 October 2009, the European Council recognised the progress made thus far and reiterated the importance of the swift continuation of the work on the establishment of the ESAs, in order to reach a general approach on these proposals. The European Council urged the ECOFIN Council to reach agreement by December 2009 on a complete package setting up a new supervisory structure in the EU. The ECB issued its formal opinion on the Commission’s proposals on 26 October 2009.⁷

3 The FSB was established at the G20 summit in London on 4 April 2009. See www.financialstabilityboard.org.

4 The de Larosière Report is available on the Commission’s website (www.europa.eu).

5 The new ESAs will be the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). They will replace the existing so-called “Level 3 Committees”, i.e. the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR) respectively.

6 Available on the Commission’s website (www.europa.eu).

7 CON/2009/88, available under http://www.ecb.europa.eu/ecb/legal/opinions/html/act_10667_amend.en.html.

The ECB expressed its broad support to the proposed legal framework for the ESRB. It also recalled that it stands ready to act as the Secretariat of the ESRB, to support the ESRB and to bring to the benefit of the ESRB, with the participation of all the members of the ECB's General Council, the macroeconomic, financial and monetary expertise of all EU central banks. Some specific comments were provided on the governance and structure of the ESRB, including the Steering Committee and the Advisory Technical Committee. In this respect, the point was made that the composition of the Steering Committee should reflect that of the General Board with the inclusion of five central bank members (in addition to the Chair and Vice-Chair of the ESRB), as stated in the Commission's proposal.

Box A.1**MACRO-PRUDENTIAL ARRANGEMENTS CONSIDERED BY THE UNITED STATES**

As part of the proposals released in the white paper entitled "Financial Regulatory Reform. A new Foundation: Rebuilding Financial Supervision and Regulation" in June 2009, which is now being discussed with Congress, the US Treasury announced the setting-up of a Financial Services Oversight Council (FSOC) in charge of systemic risk oversight.

The Council will be in charge of identifying emerging risks, as well as gaps in regulation, referring them to the relevant supervisory bodies with the authority to respond, and coordinating the responses (the FSOC is also intended to improve inter-agency cooperation in general, including the resolution of jurisdictional disputes).

It will be composed of eight members, namely the Secretary of the Treasury, acting as Chairman, and the heads of the seven federal financial regulators. The Council will be supported by dedicated staff from the Treasury.

To facilitate the monitoring of emerging threats that activities in financial markets may pose to financial stability, the Council will have the authority, through its permanent secretariat, to require periodic and other reports from any US financial firm solely for the purpose of assessing the extent to which a financial activity or financial market in which the firm participates poses a threat to financial stability. In the case of federally regulated firms, the Council will, wherever possible, rely upon information that is already being collected by members of the Council in their role as regulators.

Under the US Treasury's proposals, the Council will also have the authority to recommend the designation of any financial firm as a "Tier 1 Financial Holding Company" (Tier 1 FHC), i.e. financial firms – whether or not they own a bank – considered systemically important due to their size, leverage and interconnectedness, which will be subject to consolidated supervision by the Federal Reserve with a macro-prudential focus and stricter prudential standards. The Federal Reserve should consult the Council when setting both prudential standards and risk-management standards for systemically important payment, clearing and settlement systems and activities.

The Financial Services Oversight Council will prepare an annual report to Congress on market developments and potential emerging risks to financial stability.

In the context of the legislative discussions on the regulatory and supervisory reforms, the two houses of Congress are putting forward amendments to the US Treasury's proposals, as well as elaborating alternatives. In particular, the Senate Banking Committee has proposed the setting-up of a more powerful oversight council, which is to be called the "Agency for Financial Stability". The new body, which is to be chaired by a full-time presidential appointee, would be in charge of identifying firms of systemic relevance, would set prudential standards (with incentives to reduce risks created by size and complexity), would have the authority to break up firms that pose a threat to financial stability and would be endowed with resolution powers.

ESTABLISHMENT, ORGANISATION AND OBJECTIVES OF THE EUROPEAN SYSTEMIC RISK BOARD⁸

According to the proposals adopted by the European Commission in September 2009, the ESRB will be established as an independent body, without legal personality, responsible for macro-prudential oversight across the EU financial system.

The internal organisation of the ESRB will include (i) a General Board, (ii) a Steering Committee and (iii) a Secretariat. The General Board will be the main decision-making body of the ESRB and will be composed of voting and non-voting members. The voting members will be the Governors of the EU national central banks, the President and the Vice-President of the ECB, a member of the European Commission, and the chairpersons of the three ESAs. The non-voting members of the General Board will be a high-level representative per Member State of the competent national supervisory authorities and the President of the Economic and Financial Committee (EFC). The decisions will be taken by simple majority, with the exception of decisions concerning the publication of a warning or recommendation. In such cases, a majority of two-thirds of the votes is required.

A Steering Committee will assist in the decision-making process of the ESRB by preparing the meetings of the General Board, reviewing the documents to be discussed and monitoring the progress of ongoing work.⁹

The ECB will act as the Secretariat and therefore provide analytical, statistical, logistical and

administrative support to the ESRB. This includes, among other activities, the preparation of the meetings, the collection and processing of qualitative and quantitative information, and the conduct of analysis and assessments necessary for the fulfilment of the ESRB tasks. The Secretariat will also support the Advisory Technical Committee.

Furthermore, the ESRB will be supported by an Advisory Technical Committee, which will, upon request by the General Board, provide advice and assistance to the General Board on a number of issues that are within the scope of the ESRB.

The objectives of the ESRB are threefold. The first objective is to develop a framework for macro-prudential oversight in Europe so as to better address the issue of fragmented risk analysis at national level. The ESRB should provide high-quality macro-prudential assessments, as well as issue risk warnings and recommendations whenever potential imbalances may pose a threat to financial stability. The identification of risks with a systemic dimension and the prevention or mitigation of these risks' impact on the EU financial system, through the issuance of prompt early warnings, can be characterised as the key task of the ESRB.

⁸ This section is based on the Commission's legislative proposals, as adopted on 23 September 2009. The Commission's proposals are subject to changes before the final adoption of the legal acts within the legislative process.

⁹ The Steering Committee will be formed by the Chair and Vice-Chair of the General Board, the chairpersons of the three ESAs, the President of the EFC, a member of the Commission and five members of the General Board who are also members of the General Council of the ECB.

The second objective of the ESRB is to enhance the effectiveness of early warning systems by improving the interaction between micro- and macro-prudential analyses.

The final objective of the ESRB is to translate risk assessments into action by the relevant authorities.

RISK ASSESSMENTS AND DELIBERATIONS OF THE EUROPEAN SYSTEMIC RISK BOARD – ENVISAGED PROCESSES

Amid this broad range of responsibilities, the preparation of high-quality risk warnings emerges as a core output of the ESRB. It relates to all other responsibilities in the sense that, on the one hand, risk warnings should result from the risk surveillance and assessment tasks, and on the other hand, it could require follow-up remedial actions and the monitoring of their implementation.

As such, the core process of selecting which risks may merit a warning by the ESRB would likely need to follow a decision-tree-type mode of working, based on the two main components of macro-prudential analysis: risk surveillance and risk assessment. In such a working mode, the process would begin with monitoring and surveillance activities aimed at detecting potential sources of risk, especially financial vulnerabilities, i.e. weak points which, if unearthed, could lead to a disruption or failure in part of the financial system and potentially a financial crisis. This task would also involve sketching out potential risk scenarios connected with financial vulnerabilities and identifying potential events (or shocks) that could trigger these scenarios. Only a systematic and rigorous monitoring of potential sources of risk and vulnerabilities – based on a comprehensive information base – can help to ensure that risks are not missed or overlooked.

Starting from a broad spectrum of potential sources of risk and vulnerability, both within and outside the EU financial system, the risk

surveillance phase would be complemented by relevant data and expert knowledge on the likelihood and severity of the risks identified, with a view to separating the potentially material risks from the immaterial ones. This exercise would need to be cross-checked and complemented with information gathered through market intelligence activities and expert knowledge at the national level.

The following step in the core process would be the actual risk assessment, namely the evaluation of the possible severity of the impact of adverse risk scenarios identified on the functioning of the EU financial system, as well as an evaluation of the ability of the financial system to absorb shocks. As highlighted by the financial crisis, this exercise should also include the examination of plausible interconnections between vulnerabilities and allow for the assessment of scenarios where risks are combined; it should aim at providing a quantitative impact assessment of such potential risk scenarios. Some of the risks identified at this stage of the process could require examination in greater detail, through drill-down analysis. This would include estimates of the likelihood of systemic events occurring and the impact of risks, should they crystallise, on the financial system (e.g. via macro stress-testing) and/or the impact on the broader economy (e.g. foregone output). Finally, risk assessments should also entail an examination of the ability of the financial system to absorb the identified shocks, e.g. through existing capital buffers or considering the potential to grow buffers in the future through profit retention.

This part of the risk assessment process should support the identification and prioritisation (i.e. the assessment of materiality) of risks for financial stability in the EU. Detailed risk assessments should allow the formation of well-informed judgements on whether the identified risks merit risk warnings and, if so, whether the risk warnings should be accompanied by recommendations or advice on the measures to be taken to address the risks.

In essence, this funnelling or decision-tree process would begin with drawing up a long list of potential risks, aimed at minimising type-II errors – i.e. the likelihood that the ESRB fails to identify and issue warnings about risks that subsequently do materialise. It would be followed by the risk assessment, which would contribute to reducing the list of possible risks and vulnerabilities into a smaller set of risks that are perceived as material on the basis of relevant data and qualitative assessments. The ensuing drill-down analysis, mostly of a quantitative nature, should aim at minimising type-I errors – i.e. the possibility of identifying risks that subsequently do not crystallise or, if they do, prove not to be material – by assessing their plausibility and potential severity. This step of the process would provide elements to support deliberations regarding risk warnings and could also contribute with insights regarding appropriate mitigating actions and related policy recommendations, if deemed necessary.

It hardly needs mentioning that financial systems – comprising many and changing interlinkages – are complex and financial innovation can be expected to continue to add to this complexity. On account of this, the set of tools for systemic risk surveillance and assessment must be constantly re-evaluated, modified or replaced. This also implies that the risk assessment framework should never rely on a single model or indicator, but should rather try to draw upon a wide set of tools and information, including market intelligence efforts.

CHALLENGES FOR THE NEW FINANCIAL STABILITY FRAMEWORK

The effectiveness of the proposed new EU financial stability framework will hinge on a number of aspects, which will require further fleshing out.

First, an effective mechanism for cooperation and information exchange between the ESRB and the ESFS needs to be established, beyond their strong institutional links, (also through cross-membership) to ensure the appropriate

interplay in the new EU supervisory architecture between the macro-prudential and micro-prudential levels. In particular, in terms of access to data, the foreseen regulation envisages the ESRB having the ability to request the ESAs to provide information in summary or collective form and, should this information not be available, to request data directly from national supervisory authorities. As some individual institutions can be systemically important, the ESRB may also have access to individual data upon a reasoned request to the ESAs.

In terms of cooperation, the ESFS should benefit from the ESRB's insights into the macro-prudential environment. In some circumstances, the ESFS could also contribute to the implementation of ESRB policy recommendations. In order to structure the interplay between the ESRB and the ESFS, cooperation and information-sharing procedures will need to be put in place, including the necessary confidentiality safeguards.

Second, an essential task of the ESRB is to issue risk warnings and recommendations that are addressed to the Community as a whole, to one or more Member States, to one or more ESAs and to one or more national supervisory authorities. An important factor supporting this task will be the enhancement of the analytical tools necessary to support the systemic risk analysis. The risk warnings and recommendations made by the ESRB will not be legally binding; they will have a so-called “act or explain” nature. This implies that, if the addressee agrees with the recommendation, it must communicate the actions it will undertake to follow the recommendation. If the addressee does not agree with a recommendation, the addressee must explain the reasons for not following up. The fact that the ESRB may decide on a case-by-case basis whether to make a warning or recommendation public may increase the pressure to follow up on the recommendation, but it could also trigger adverse financial market reactions. Hence, given that it has no legal powers, the ESRB will need to rely on a combination of (i) solid technical analysis,

(ii) credibility and (iii) peer pressure as the sources of its legitimacy.

Finally, according to the proposed regulation, the ESRB shall be accountable to the European Parliament and the ECOFIN Council. It is envisaged that such reporting will take place at least annually. While the framework is still under consideration, it can be presumed to allow for flexibility in the practical implementation of the reporting obligations. With respect to the reporting obligations, the reporting of the ESRB should be clearly separated from the reporting of the ECB on monetary policy. The practical arrangements will need to be agreed upon by the ECOFIN Council, European Parliament and ESRB.

CONCLUDING REMARKS

The establishment of the ESRB represents a great step forward in the enhancement of macro-prudential analysis and oversight in the EU. The credibility and effectiveness of the ESRB, however, will depend, to a large extent, on the quality of its risk assessments and on its ability to translate those into concrete and adequate policy recommendations and, ultimately, actions. As such, it is essential that the challenges highlighted here are addressed in an appropriate manner, facilitating the functioning of the new EU supervisory architecture. In addition, due consideration should also be given to the developments taking place at the international level, bearing in mind that the crisis has confirmed the global dimension of the financial system.