The road ahead after de Larosière
Karel Lannoo

The decisions taken by the European Finance Ministers on 9 June 2009, and subsequently adopted by the European Council on the 18-19 June, broadly implement the proposals on European financial supervision put forward by the de Larosière Committee and the European Commission, and also provide the necessary detail. From 2010 onwards, a new structure should be in place to ensure more integrated European macro- and micro-prudential oversight. The macroeconomic body – the European Systemic Risk Board (ESRB) – will be consultative in nature and will largely function within the context of the ESCB (European System of Central Banks). Hence its implementation should not be too problematic. The different functional authorities coordinating micro-prudential supervision will be established by the Council in the autumn, basically upgrading the existing Committees, but they will have a substantially increased workload, which raises important structural and organisational issues.

Apart from the adaptation of the institutional structure, the EU is currently implementing a comprehensive regulatory response to the crisis, following at the same time a globally dictated agenda pursued by the G-20 and a set of ‘single market’ measures. The latter result from inconsistencies (e.g. deposit guarantee schemes) and gaps (e.g. mortgage credit) in the existing regulatory framework.

This ambitious workload coincides with important changes afoot on the EU scene, which could delay the legislative process. A new European Parliament is coming into office, and will take some time to get a grip on the different dossiers. With more than 50% of the elected MEPs serving for the first time and more than 100 important positions to be decided upon in the new EP, a fast track of new legislation cannot be expected. In addition, a new college of European Commissioners will be appointed after the summer, and a new work programme adopted. Moreover, the possible implementation of the Lisbon Treaty by the end of the year could result in further seismic shifts. In short, the circumstances in the European Union are not especially favourable at the present time for achieving an enormous legislative agenda.

The de Larosière agenda

The Council of Finance (Ecofin) Ministers of 9 June 2009 agreed upon a new structure for supervision in the EU, consisting of essentially four new entities: a European Systemic Risk Board and a European System of Financial Supervisors (ESFS), comprising three functional authorities (see figure below). The Council conclusions describe in much detail the framework and responsibilities of the new supervisory bodies. Implementation of either of these decisions, however, still raises problems: of a conceptual nature for the ESRB, and of a more organisational character for the ESFS.

The Ecofin Council stated in its conclusions that “regulation and supervision in Member States and in the EU must be enhanced in an ambitious way ensuring trust, efficiency, accountability and consistency with the allocation of responsibilities for financial stability, taking into account the responsibility of Finance Ministers.” Ministers probably wanted to recall earlier discussions in the Ecofin on financial supervision in 2002, and remind the public that, because of the accountability to taxpayers, they are in control. The respect of fiscal sovereignty is further reiterated several times in the Council conclusions.

1 Council conclusions on Strengthening EU financial supervision, Luxembourg, 9 June 2009.
2 See conclusions of the Ecofin Council of May 2002.
The European Systemic Risk Board (ESRB) at the centre

The ESRB will be at the centre of the new system, even if this body is only consultative. Its nine-member Steering Committee is composed of the four ESCB members (including the President of the ECB), the three chairs of the European Supervisory Authorities (ESAs), a member of the EU Commission and the President of the Economic and Financial Committee (EFC). The dominance of the central bankers in the governance of the new structure is even clearer in the General Board of the ESRB, which comprises, apart from the Steering Committee members, all central bank governors of the EU 27. The creation of the Steering Committee, not foreseen in the de Larosière report, probably responds to the criticism that the ESRB would be too unwieldy to be effective.

The ESRB will have its seat in the ECB and will rely on the analytical and administrative services and skills of this well-reputed and established institution. Thus it will also be controlled by the ECB. The Finance Ministers have only one representative in the ESRB. Hence, notwithstanding the declaration of the Finance Ministers that they want to be in the driver’s seat, the power will reside with the central bankers.

The ECB had reacted against the establishment of the ESRB as a separate legal entity, which the European Commission initially proposed, and preferred the use of Art. 105.6 of the EU Treaty to confer macro-prudential tasks to the ECB/ESCB. However, as the latter requires unanimity in the EU Council – and therefore seemed very improbable – the ECB preferred the former option, but functioning as a consultative body only. In a confidential note on the Commission’s working document on European financial supervision, it wrote: “The establishment of the ESRB as an EU body with legal personality would create a separate EU quasi-central banking institution with responsibilities that are overlapping with the financial stability tasks performed by the ECB/ESCB”. It noted that a separate entity would become confusing and raise questions of representation and competence.

The ESRB should:

- define, identify and prioritise all macro-financial risks;
- issue risk warnings and give recommendations to policy-makers, supervisors and eventually to the public;
- monitor the follow-up of the risk warnings, and warn the EU Council in the event that the follow-up is found to be inappropriate;
- liaise with international and third country counterparts; and
- report at least bi-annually to the EU Council and European Parliament.

The ESRB will strengthen the ECB’s role also in another sense. Through the ESRB, the ECB will have access to micro-prudential information. Throughout the financial crisis, ECB officials have criticised the lack of access to supervisory information of financial institutions. In its confidential memo to the Commission President, the ECB requested the right to collect supervisory information: “The ECB/ESCB...”

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should be provided with the task to collect and share macro-prudential and aggregated micro-prudential information (...) which is necessary for the performance of the tasks of the ESRB. The Ecofin Council decided differently, however, stating that the “central European database should be established and managed by the European Supervisory Authorities.” But this information should be shared with the ESRB “subject to specific confidentiality agreements”, it was added.

Crisis management is not mentioned as a task of the ESRB, but of the ESFS in an exploratory way. This is a departure from the ad-hoc agreement reached in the European Council in October 2008, whereby the President of the ECB (in conjunction with the other European central banks) formed part of a financial crisis cell, with the President of the Commission, the EU Council and the Eurogroup.

The task is now essentially for the ECB to bring the ESRB into existence. Although the ESRB can depend on formidable back-office support from the ECB, it will face significant conceptual challenges. Will it be capable, for example, of clearly identifying and reacting to a bubble amongst the hundreds of possible risks on the horizon? Will it have sufficient authority and the necessary imagination to challenge conventional wisdom? Will the reporting tree function and the reaction be adequate? Will the boundary with the micro-financial tasks be drawn in an unambiguous way? The ECB needs to realise that the responsibility it takes in assuming this task could negatively impact its reputation in the future, and eventually its independence in setting monetary policy. Hence the ESRB should have sufficient independence from the ECB. Any further discussion on this subject, which is also taking place in the US with the proposed creation of a Financial Services Oversight Council, should proceed with extreme caution. However, it seems that, because of these conceptual challenges and institutional issues, the European solution of creating a purely consultative body, separate from the central bank, finance ministers or supervisors, is the right step forward. It respects their respective roles on how to act upon the recommendations of the ESRB.

The European System of Financial Supervisors

The establishment of the ESFS is a daunting task. Unlike the ESRB, the authorities can hardly rely on an existing structure, but almost need to start from scratch, or need to magnify the tasks currently performed by the Committees to an exponential degree. It is for this reason (among others) that we recommended establishing these authorities under a single roof from the very beginning, in order to share as much as possible a common administration and avoid unnecessary duplication of effort and confusion of responsibilities. However, a single roof would have meant a single location, the selection of which would have opened a Pandora’s box that the EU Council preferred to keep closed. Problems would inevitably have arisen from the fact that the Committees forming the basis of the three future authorities have their seats in the (business) capitals of the three most important member states of the EU, respectively Paris, London and Frankfurt.

The ESFS will be responsible for:
- moving towards the realisation of a single rulebook,
- ensuring harmonised supervisory practices,
- strengthening the oversight of cross-border groups and supervise pan-European entities,
- establishing a central European database aggregating all micro-prudential information and
- ensuring a coordinated response in crisis situations.

The three authorities can be expected to be established as regulatory agencies under EU law, following Art. 95 of the EU Treaty. Although the Council stated that the choice of the legal basis has not yet been taken, the Commission proposed in its Communication Art. 95 of the EU Treaty, relating to the adoption of measures for the approximation of legislation for the functioning of the internal market. Since the agencies will work on the development of a single rule book to ensure uniform application of rules in the EU, they will contribute to the functioning of the internal market.

The use of Art. 95 has another advantage, in that the decision to establish the authorities could be taken by qualified majority vote (QMV) in the EU Council. This compares to Art. 308, which requires unanimity. As some member states may not be so keen to

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4 Ibid., p. 4.
6 It should be recalled that the ECB already has a committee under its roof with responsibility for some of the functions expected of the ESRB. Its Banking Supervisory Committee (BSC) brings together banking supervisors of all the EU countries, and not only the eurozone, to discuss macro-prudential and financial stability issues. In response to criticism on the lack of macro-prudential oversight in the EU, the ECB explicitly indicated in 2001 that its Banking Supervision Committee would perform that role (see EFC, 2001, p. 7). It is expected that as a result of the crisis financial stability will become a more pronounced objective of the ECB (see De Grauwe & Gros, 2009).
delegate large powers to the agencies, QMV would allow the European Commission to go for a broader mandate. On the other hand, Art. 95 requires co-decision with the European Parliament, which is not the case for Art. 308, implying that the decision process under Art. 95 may take longer. In any case, for such important decisions, it is advisable to have them taken by as unanimous approval as possible.

Much now depends on the precise elaboration of the mandate of the agencies in the Commission’s proposals, which the Ecofin Council expects in the early autumn 2009 “at the latest”. Among the 28 EU regulatory agencies existing at present, no general rules apply governing their creation and operation. They were set up on a ad hoc basis rather than via a coherent administrative and/or regulatory method. Consequently, large differences exist between them when it comes to their functions, organisational structure and funding provisions. Given the supervisory problems raised by the crisis, a precise proposal on the mandate, tasks, organisation, decision-making procedures, funding and accountability of the new agencies is crucial.

In comparison to the tasks assigned to the ‘Level 3’ Committees (3L3), as created by the 2001 Lamfalussy report, the workload has been magnified significantly. Whereas the 3L3 had an essentially advisory task on regulatory matters – advising the European Commission on implementing rules – the new authorities will in addition have many supervisory duties. The realisation of a single rulebook and the consistent application of EU rules continue and extend regulatory tasks of the Committees. In this regard, the Council conclusions mention that a mechanism should be developed to ensure more consistent application of EU law and a tougher sanctioning regime for cases of non-respect. But the addition of supervisory responsibilities and the constitution of a central supervisory database will impose a new and heavy workload. The Council conclusions mention, inter alia:
- coordinating the supervisory analyses of financial groups,
- ensuring consistency in supervisory outcomes across financial groups,
- participating and eventually mediating in supervisory colleges,
- supervision of pan-European entities and
- developing common training for supervisors.

To imagine what this means in terms of increased workload, one can recall that on the banking side alone, there are 123 different supervisory colleges (Lannoo, 2008, p. 32). If the new European Banking Authority (EBA) needs to participate in all these meetings, and coordinate the supervisory analyses, this will require a multiplication of the staff of the current Committee of European Banking Supervisors (CEBS). For comparison, the average number of staff members of the European regulatory agencies is 157 persons (Andoura & Timmerman, 2008, p. 11).

The extensive supervisory tasks may cause problems with the member states and raise the question of the powers of the agency. According to Court jurisprudence, the authorities can not exercise more powers than the delegating authority possesses under the EU Treaty. Some of the responsibilities listed above could be on the borderline between tasks falling to the EU under the Treaty, and those remaining a member state competence. In addition, the question can be raised who is in charge of enforcement. Under the 2001 Lamfalussy report, the hardly mentioned ‘Level 4’, i.e. enforcement, was a Commission competence, whereas under the new proposals on the table, the ESAs would share enforcement competences with the EU Commission.

The coming into force of the Lisbon Treaty should facilitate the implementation of this new framework, particularly with the single rulebook and the harmonised supervisory practices. If adopted, the Lisbon Treaty would clarify the hierarchy of norms in the EU’s regulatory framework and distinguishes between legislative acts, delegated acts and implementing acts. It would replace the current ‘comitology’ framework, which, for financial markets, was the centrepiece of the Lamfalussy report. A delegated act assigns to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act. An implementing act will be adopted “where uniform conditions for implementing legally binding Union acts are needed”, which confers implementing powers on the Commission. This should allow the current level 3 of Lamfalussy to become binding.

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8 The basis could be challenged by the member states. In 2004, the UK challenged the choice of Art. 95 EC as the legal basis of the European Network and Information Security Agency (ENISA) before the European Court of Justice and stated that Art. 308 EC was the only possible legal basis. The Court ruled that the use of Art. 95 EC was appropriate for ENISA, as it constituted a part of the normative context directed at completing the internal market in the area of electronic communications. See Andoura & Timmerman (2008), p. 7.

9 Ibid., p. 9.

10 See the landmark Meroni case (9/56, 1957-1958), as quoted in Andoura & Timmerman (2008, p. 12) in which the European Court of Justice clarified the conditions under which a delegation of powers could be granted to a new entity.
The degree of independence to be accorded the ESAs remains ambiguous. The Council conclusions reiterate that the ESAs should be independent vis-à-vis both the national authorities and the European institutions. But they will assist the Commission in the consistent interpretation and application of Community law. And the decisions they take should not impinge on fiscal responsibilities of the member states, which severely restricts their powers. A problem in this regard is the supervision of pan-European entities. Recent EU decisions have already anticipated the creation of the ESAs. For example, the new regulation on credit rating agencies (CRAs) gives the Committee of European Securities Regulators (CESR) certain competences in the supervision of these bodies. CESR should facilitate the registration of CRAs in the EU and can mediate in the supervisory college. Other possible areas for pan-European supervision are central counterparties and securities settlement systems. The Ecofin Council conclusions note that some member states do not agree with this approach, since it could affect national fiscal responsibilities (Council conclusions, p. 5). The same reasoning applies for crisis management, where it seems that the ESAs will exercise limited responsibility for emergency regulatory decisions, such as short-selling restrictions. However, mediating in supervisory colleges has fiscal implications, nolens volens.

The Council conclusions are less detailed on the governance of the ESAs than on the ESRB. They only call for a Steering Committee of the ESAs to reinforce mutual understanding and coordinate information-sharing. This reinforces our view that the ESRB will be at the centre of the new supervisory architecture, as they will have the vue d’ensemble.

The weakness of the European solution for micro-prudential supervision is that, out of realpolitik considerations, the EU chose to maintain the functional model of supervision at EU level. Supervision by objective would have been better adapted, leading, following the principle of subsidiarity, to a more rational and efficient allocation of responsibilities at European level. The current structure will give rise to duplication of tasks and confusion in the allocation of responsibilities. A more integrated structure, for example, to supervise pan-European entities or constitute a European supervisory database would be much more effective. On the other hand, compared to the proposed supervisory reform in the US, where the only structural change on the micro-prudential side is the merger of the Office of Thrift Supervision (OTS) and the Office of the Controller of the Currency (OCC, the European structure may over time become more integrated, provided the mandate of the new authorities is sufficiently comprehensive, and the EU member states contribute constructively to the new structure.

### The post-crisis regulatory agenda

The new European Parliament will have to face the dual challenge of dealing with the legislation on the adaptation of the institutional structure on top of the post-crisis regulatory agenda. The latter is driven by international (G-20) as well as European single market considerations. Some parts of this agenda have already been completed, but others have just been initiated or are still in the pipeline.

The crisis revealed important shortcomings in the regulatory framework, to the extent that a core principle of the single market, the single passport and home country control, was called into question. To restore this principle, the European Commission will have to engage in moving towards a much higher degree of harmonisation in certain areas. Following the EU’s 1993 deposit protection directive, three different schemes of protection co-exist: the protection offered the home country (applicable to the head offices and its branches or through free provision of services), the protection offered the host country (in case the bank is a subsidiary of a foreign bank) and the home country scheme ‘topped up’ with the level offered by the host country (in case the level of protection for a branch operating in the host country is lower than that of its home country). Until the crisis broke out, an overwhelming majority of consumers was not aware of the consequential differences in protection schemes. In the midst of the crisis, the member states provisionally agreed in the EU Council to increase the minimum levels to €50,000, but did not change schemes of the basics of the 1993 EU directive, nor the method of funding or the statute. The European Commission will need to report before the end of 2009 on how to reform the system for the long term.

Other elements will need to be reformed to get consumers back on board of the single market. Mortgage lending, for example, is not subject to any degree of EU harmonisation, whereas (short-term) consumer lending is. Although mortgage lending is about 9 times more important than other forms of consumer credit, a consultation in 2007 concluded that the different forms of national legislation seemed to work well enough, and that there was no immediate need for European harmonisation (European Commission, 2007). However, principles such as responsible lending and loan-to-value ratios could well be harmonised and enforced at European level, as lax standards in one member state has European-wide implications.

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### Status of post-crisis financial services legislation

<table>
<thead>
<tr>
<th>Measure</th>
<th>Purpose</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depositor protection schemes</td>
<td>Increase minimum level of protection to €50,000</td>
<td>Adopted October 2008, report by end-2009</td>
</tr>
<tr>
<td>Credit rating agencies</td>
<td>Introduce single licence</td>
<td>Adopted April 2009</td>
</tr>
<tr>
<td>Amendments to capital requirements</td>
<td>- securitisation</td>
<td>Directive (adopted April 2009)</td>
</tr>
<tr>
<td>Directive (CRD)</td>
<td>- executive remuneration</td>
<td>Draft directive (July 2009)</td>
</tr>
<tr>
<td>- trading book and complex</td>
<td>- min. 5% on a bank’s books</td>
<td>Draft directive (July 2009)</td>
</tr>
<tr>
<td>financial products</td>
<td>- extra charge for high pay packages</td>
<td>Draft directive (July 2009)</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>Regulate non-regulated segment of fund industry</td>
<td>Draft directive (April 2009)</td>
</tr>
<tr>
<td>Prospectus Directive</td>
<td>Possible review</td>
<td>Consultation (January 2009)</td>
</tr>
<tr>
<td>Investor compensation schemes</td>
<td>Possible review</td>
<td>Consultation (February 2009)</td>
</tr>
<tr>
<td>UCITS IV</td>
<td>Implementing measures</td>
<td>Consultation of CESR (March 2009)</td>
</tr>
<tr>
<td>Market abuse</td>
<td>Improve and simplify directive</td>
<td>Consultation (April 2009)</td>
</tr>
<tr>
<td>Depositaries of funds</td>
<td>Segregate funds from depositaries</td>
<td>Consultation (May 2009)</td>
</tr>
<tr>
<td>OTC markets</td>
<td>Transparency, mandate some central clearing</td>
<td>Consultation (June 2009)</td>
</tr>
<tr>
<td>European Systemic Risk Board</td>
<td>Indentify macro-financial risks</td>
<td>Consultation (June 2009), draft regulation (September 2009)</td>
</tr>
<tr>
<td>European Banking Authority</td>
<td>Coordinate banking regulation and supervision</td>
<td>Consultation (June 2009), draft regulation (September 2009)</td>
</tr>
<tr>
<td>European Insurance Authority</td>
<td>Coordinate insurance regulation and supervision</td>
<td>Consultation (June 2009), draft Regulation (September 2009)</td>
</tr>
<tr>
<td>European Securities Markets Authority</td>
<td>Coordinate sec. markets regulation and supervision</td>
<td>Consultation (June 2009), draft Regulation (September 2009)</td>
</tr>
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### A forceful Commissioner in charge

A prerequisite to a credible European agenda is a forceful and credible Commissioner in charge. The outgoing Commissioner for the single market had by the end of his term lost all credibility. Charlie McCreevy’s initial slogan was “regulatory pause” after his predecessor Frits Bolkstein had pushed through the heavy Financial Services Action Plan. The Commissioner gave priority to market-driven solutions, including self-regulation, before going for new regulation. Even in the first months of the crisis, McCreevy hesitated to call for new regulation, for, for example, credit rating agencies or deposit guarantee schemes. He also did not dare to oppose the dominant attitude in the EU Council of Finance Ministers that the crisis did not signal the need to introduce changes to the institutional structure of supervision. It was only by May 2008 that the Commissioner started to change his position and called for a regulatory response. Moreover, the initiative to establish the de Larosière Group in October 2008 was taken by the Commission President, not by Commissioner McCreevy.

In a related vein, consideration should be given to a possible re-distribution of the internal market portfolio. As one of the cornerstones of the EU, the internal market could command the full attention of two or three commissioners. Financial services matters alone deserves a single commissioner, especially for the next five years, when the Commissioner will have to push a heavy agenda through the EU Council and European Parliament, and take on additional responsibilities in the ESRB and ESAs. A forceful Commissioner will thus be extremely important for the Commission to regain the initiative in this policy domain.

### Conclusion

The European Commission faces a difficult and precise balancing act in drafting the proposals for a new framework for EU supervision “by early autumn 2009 at the latest”. It will need to come forward with draft legislation laying down as clearly as possible the objectives, functions, organisation, governance and funding of the new entities proposed by the de Larosière report, while at the same time garnering the support of a ‘qualified’ majority of member states. Since the Commission will most likely follow the Art. 95 route, its proposals will go as far as possible within the limits of the EU Treaty. But the proposals will for the first time mark a structural change in the framework for financial supervision in the EU.
creating three new entities with separate legal personality, and a huge workload.

The measures to be decided upon in the follow-up to the de Larosière report come on top of the consultations and proposals for new measures that the European Commission is involved in as a result of G-20 commitments and the further completion of the single market. All these will have to be pushed through in a context of a new European Parliament and a new European Commission, which does not augur for a swift decision process.

But will this be enough to restore the single market? The financial crisis and the large state aid packages have forced ailing banks to re-focus on their home market and reduce their activities abroad. Market integration is declining and competition diminishing. It will take time before the effects of the measures discussed above become visible and the single market process advances again.

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