Fair value accounting and procyclicality: mitigating regulatory and accounting policy differences through regulatory structure reforms and Enforced Self Regulation

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ABSTRACT

In what ways can changes to the structure of regulation (as well as other regulatory reforms) mitigate the effects of policies which trigger financial instability? More specifically policies, information asymmetries or externalities which could give rise to bank contagion, systemic/liquidity risks or procyclical effects?

Whilst acknowledging that accounting standards play a fundamental role in addressing problems which could contribute to information asymmetries and ultimately systemic risks, this paper also highlights why the type of regulatory structure, clear allocation of responsibilities between regulators, as well as measures aimed at fostering accountability, constitute vital elements which could serve as safeguards in mitigating procyclical effects (as well as other factors) which could trigger financial instability. In achieving this aim, the paper focusses on the rationale for fair value accounting, as well as problematic issues arising from its implementation.

The adoption of international accounting standards is considered to have a vital role in contributing to financial stability. This paper will also illustrate how the implementation of accounting standards and policies, in certain instances, have contrasted with Basel Committee initiatives aimed at mitigating procyclicality and facilitating forward looking provisioning. More importantly, the paper will highlight how and why differences between regulatory and accounting policies could (and should) be mitigated.

Key words: stability, liquidity risks, systemic risks, pro cyclicality, fair values, information, certainty, regulation, central banks, accountability, macro prudential regulation

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A. Introduction

The aftermath of the recent global Financial Crisis has witnessed changes to the structure of financial regulation, as well as policy measures aimed at fostering financial stability. These respective developments are evidenced by reforms currently being undertaken in the UK and legislative proposals being adopted by the European Commission to consolidate Financial Supervision in Europe.

Whilst a previous paper focussed on ways whereby auditing standards could contribute in mitigating the devastating consequences of the recent Financial Crisis, the present paper focuses on the issue of fair value accounting, the benefits attributed to such measurements – as well as its disadvantages. Some problems identified with international accounting and auditing standards prior to the 2007/2009 Financial Crisis, as identified in the paper include:

− The fact that international accounting and auditing standards, on their own, do not prescribe rules which provide guidance of how regulation should be effectively carried out
− The inappropriateness of the scope of application of international standards.

Within this context, the role of regulation and regulatory authorities is emphasised. This also underlines why auditing and accounting standards serve as complements in addressing issues relating to financial stability, why changes to regulatory structures and further measures aimed at addressing systemic risks will be necessary to facilitate the (International Accounting Standards Board) IASB and Basel Committee’s efforts.

The paper will commence with a section (section two) which discusses measures and initiatives that have recently been undertaken by national and supranational authorities in their goal to foster financial stability. The section will also highlight the focus which is increasingly being placed on macro prudential measures as well as measures aimed at mitigating procyclicality.

Section three will then be linked to section two through the all important need to foster accountability. It will also address how differences in regulatory and accounting policies could be better reconciled – hence facilitating regulatory convergence as well as the harmonisation of accounting and auditing standards.

Having considered the importance of transparency and the disclosure of information in fostering accountability (under section three), the bridge to section four will then consider the principal

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3 ibid
advantage attributed to fair value measurements – that is the quality of information it provides. In so doing, it will link this discussion to section four which considers the contribution of fair value measurements to pro cyclicality and systemic risks. Section five then proceeds with an analysis and discussion of recent efforts which have been undertaken at supranational level – efforts aimed at consolidating financial supervision. In this context, it will consider developments and initiatives which have resulted in the creation of the European Systemic Risk Board and the European System of Financial Supervisors. It will also highlight the distinction drawn between the functions of these bodies through their roles in micro and macro prudential supervision.

The concluding section will then consider further areas which need to be addressed under the recurring theme of this paper: that is, the need to harmonise regulatory and accounting policies in achieving the goal of promoting financial stability.

B. Analysis of Recent Efforts Aimed at Facilitating Financial Stability: Efforts undertaken by national authorities, supra national authorities and international standard setting bodies

Recent measures aimed at fostering financial stability have focussed on macro prudential measures as well as measures aimed at mitigating pro cyclicality. The Basel Committee on Banking Supervision has been engaged in several initiatives, in collaboration with its introduction of Basel III, which are aimed at mitigating procyclicality. Such initiatives include:⁴

- the assessment and dampening of the cyclicality of minimum capital requirements;
- the facilitation of forward-looking provisioning;
- the adoption of a regulatory framework for capital conservation and countercyclical buffers;
- the introduction of a minimum leverage ratio.

According to Weber, „financial regulation can be enacted by governmental authorities such as parliaments, executive bodies and public institutions, and self regulatory agencies – the latter either having a delegated competence to devise regulations or to impose regulations on members of a specific market sector in a non mandatory way.“⁵ He also adds that the experience of the Financial Crisis and the present situation in financial market law, requires a rethink of theoretical concepts underlying international financial regulation and supervision.⁶

The need for changes to the structure of financial regulation in the UK became evident following the Northern Rock debacle which exposed weaknesses in the tripartite arrangement between the Financial Services Authority (FSA), the Bank of England and the Treasury. The tripartite regime is to be abolished – with the result that a new prudential financial services regulator will operate (as a subsidiary of the Bank of England).⁷

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⁴ R Moreno, „Policymaking from a Macro prudential Perspective“ BIS Working Paper No 336, January 2011 at page 13 of 24
⁶ Insodoing, he further elaborates by examining „three closely related theoretical concepts which offer a valuable framework for analysis without pre determining how regulatory responsibilities should be allocated.“ See RH Weber, „Multilayered Governance in International Financial Regulation and Supervision“ Journal of International Economic Law 13(3) 683-704 at page 687
⁷ See Speech at The Lord Mayor’s Dinner for Bankers & Merchants of the City of London by The Chancellor of the Exchequer, The Rt Hon George Osborne MP, at Mansion House <http://www.hm-treasury.gov.uk/press_12_10.htm>
In the words of the Chancellor, „The Bank of England was mandated to focus on consumer price inflation to the exclusion of other things. The Treasury saw its financial policy division drift into a backwater. The FSA became a narrow regulator, almost entirely focussed on rules based regulation. No one was controlling levels of debt, and when the crunch came no one knew who was in charge.“ see ibid
Prior to the Northern Rock debacle and indeed the onset of the recent Financial Crisis, many doubts had been expressed about the tripartite arrangement which existed between the Financial Services Authority, the Bank of England and the Treasury. The transfer of the Bank of England's supervisory powers to the FSA through the Bank of England Act 1998 had come to many as a huge surprise – since the Bank is better equipped in several respects relating to financial stability and should ideally have been involved (to a greater extent) in financial supervision than was previously the case. The aftermath of the 2007/08 financial crisis has witnessed the enactment of legislation such as the Banking Act of 2009 which has not only introduced greater statutory powers for the Bank of England, but also the Special Resolution Regime.\footnote{For a consideration of developments which have necessitated greater involvement and a greater role for central banks in financial regulation and supervision, see M Ojo, „ Central Bank's Role and Involvement in Bank Regulation: Lender of Last Resort Arrangements and the Special Resolution Regime (SRR) http://mpra.ub.uni-muenchen.de/15771/ and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420812}

In addressing certain fundamental questions\footnote{See Speech at The Lord Mayor’s Dinner for Bankers & Merchants of the City of London by The Chancellor of the Exchequer, The Rt Hon George Osborne MP, at Mansion House <http://www.hm-treasury.gov.uk/press_12_10.htm> in conceding to the fact that „fundamental problems of culture and regulatory structure still appear to exist“, he also drew attention to the following questions: How would less box-ticking and more exercise of judgement be ensured? What are the tools of macroprudential regulation and who should exercise them? Can the macroprudential regulator do their job if they don’t have an intimate knowledge of what is happening in individual firms?} related to macro prudential regulation, an interesting observation was made by the Chancellor of the Exchequer in underlining reasons for the intention to assign to the Bank of England control of macro-prudential regulation and oversight of microprudential regulation.\footnote{See Speech at The Lord Mayor’s Dinner for Bankers & Merchants of the City of London by The Chancellor of the Exchequer, The Rt Hon George Osborne MP, at Mansion House <http://www.hm-treasury.gov.uk/press_12_10.htm>}

„Only independent central banks have the broad macroeconomic understanding, the authority and the knowledge required to make the kind of macro-prudential judgments that are required now and in the future.“

He also highlighted another important lesson which was drawn from the recent Crisis, namely that:\footnote{ibid}

— because central banks are the lenders of last resort, they need to be familiar with every aspect of the institutions that they may have to support, they must also be responsible for day-to-day micro-prudential regulation as well - the case being particularly strong where the banking system is highly concentrated as it is in the UK, where the boundary between micro and macro-prudential regulation is not easy to define.

In Lastra and Garicano's opinion, „the macro supervisor should be less independent than central banks are now in their monetary policy responsibilities.“\footnote{See Principle Five, RM Lastra and L Garicano, „ Towards a New Architecture for Financial Stability: Seven Principles“ Journal of International Economic Law 13(3) at page 616} They also respond to the question „How can giving freedom (ie independence) to unelected officials be reconciled with a society remaining democratic?“ with the answer: „through accountability“.
C. Enforced Self Regulation and Accountability.

In terms of flexibility, compliance, enforcement and accountability, the Enforced Self Regulation model is considered to confer greater benefits than self regulation.\textsuperscript{13} “Enforced self regulation represents an extension and individualization of the “co-regulation.” theory. Co regulation, as distinct from enforced self regulation, is usually taken to mean industry-association self regulation with some oversight and/or ratification by government.\textsuperscript{14}

Although the Enforced Self Regulation model is considered to offer greater possibilities whereby corporate agents could be held accountable – than is the case under self regulation, there is greater scope for such a model to be optimised under the model which incorporates both Enforced Self Regulation and Regulatory Competition.

With the Enforced Self Regulation and Regulatory Competition model, whilst the firm is subject to mandatory regulations under the Enforced Self Regulation model, it is also subjected to a second level of regulation under Basel II (meta regulation) – which serves as an additional check on the self regulatory processes undertaken by the firm. This constitutes a reason why such a model is considered to provide greater accountability than Enforced Self Regulation.

Such a model is represented diagrammatically below:

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Basel Committee ----> Meta Regulation --> State --> Enforced Self Regulation --> Firm
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Other actors involved in the model could include trade associations and bodies which represent industry and consumer interests, and non governmental organisations.

Disclosure and transparency constitute fundamental elements which foster accountability. Transparency is considered to be „a beneficial element in agency relationships because more information about the agent makes the agent more accountable to the principal.“\textsuperscript{15} However circumstances whereby „committing to the concealment of certain kind of information“ could prove beneficial to the principal, have also been identified.\textsuperscript{16}

Information, certainty and uncertainty, transparency and disclosure are all factors which contribute to risk taking levels and bank contagion. The potential of banking regulations and disclosure requirements to impact risk taking levels is not only dependent on certain factors such as the dissemination of information to appropriate recipients, appropriate volume of disseminated information, when to disseminate such information, but also on other factors such as effective corporate governance measures aimed fostering monitoring, supervision and accountability. Ways whereby the disclosure and transparency of vital information for investors could serve as a source


\textsuperscript{14} I Ayres and J Braithwaite, Responsive Regulation: Transcending the Deregulation Debate Oxford University Press at page 102; Also see P Grabosky and J Braithwaite Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies, (1986) at page 83 Oxford University Press, Melbourne.


\textsuperscript{16} See ibid at page 46 of 51
of impediment to financial stability (facilitate the spread of systemic risks), are therefore also dependent on the timing of the disclosure of such information.

Fair value measurements are favoured in contrast to historical accounting principally because of the value of information they provide and contain – namely: more complete, accurate and timely information. However certain concerns have been raised in relation to the extent of their use – particularly in the aftermath of the recent Financial Crisis. The following section is dedicated to a consideration of fair value measurements and their impact on the recent Financial Crisis.

D. Contribution of Fair Value Measurements to Pro cyclicality and Systemic Risks

As highlighted in a previous paper, accounting standards' contribution to procyclicality and particularly, the pro cyclical nature of accounting, is attributed to two principal elements:

- Fair value measurements
- The treatment of impairments.

Whilst results of a certain sample generated by Khan illustrate and support the evidence that „a more fair value-oriented accounting regime is associated with an increase in bank contagion above and beyond that which exists as a result of trade and financial linkages in the banking industry“, Laux and Leuz argue in contrast (and based on their analysis), that fair value accounting (frequently also referred to as mark-to-market accounting), is unlikely to have contributed to the severity of the 2008 Financial Crisis in a major way. Furthermore, they add that „while there may have been downward spirals or asset fire sales in certain markets, little evidence supports the fact that such effects are the result of fair value accounting.“

ii) Advantages and Disadvantages of Fair Value Measurements.

The principal advantage attributed to fair value measurements has already been highlighted – namely, the value of information they incorporate in the financial statements – such value being more complete and accurate than that provided by historical cost accounting.

Problems identified with fair value accounting, as highlighted by Ball, include:

- Market liquidity is a potentially important issue in practice and spreads could be large enough to cause substantial uncertainty about fair values.
- In illiquid markets, trading by managers could influence traded – as well as quoted prices hence allowing them to manipulate fair value estimates.

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- The potential for fair value accounting to become "mark to model" accounting when liquid market prices are not available
- Tendency for fair value accounting to increase opportunities for manipulation when "mark to model" accounting is employed to simulate market prices (since managers are able to influence both the choice of models and the parameter estimates).

E. Recent Efforts Aimed at Consolidating Financial Supervision at Supra national Level

In line with arrangements aimed at "sustainably reinforcing financial stability throughout the EU, ensuring that the same basic technical rules are applied and enforced consistently, identifying risks in the system at an early stage, and facilitating the ability to act together far more effectively in emergency situations and in resolving disagreements among supervisors", the European Commission adopted draft legislation in 2009 which created the new European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS).

Functions of the European Systemic Risk Board (ESRB) are "to monitor and assess risks to the stability of the financial system as a whole ("macro-prudential supervision"), provide early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks."²²

The European System of Financial Supervisors (ESFS) serves to supervise "individual financial institutions ("micro-prudential supervision"), consisting of a network of national financial supervisors working in tandem with new European Supervisory Authorities, created by the transformation of existing Committees for the banking securities and insurance and occupational pensions sectors."²³

In the aftermath of the launch of the three European Supervisory Authorities on the 1 January 2011, the Commission proposed to make changes to legislation in the areas of insurance and securities regulation – measures aimed at facilitating the efficient functioning of the new authorities.²⁴

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²² Ibid; "The ESRB will have the power to issue recommendations and warnings to Member States (including the national supervisors) and to the European Supervisory Authorities, which will have to comply or else explain why they have not done so. The heads of the ECB, national central banks, the European Supervisory Authorities, and national supervisors, will participate in the ESRB. The creation of the ESRB being in line with several initiatives at multilateral level or outside the EU, including the creation of a Financial Stability Board by the G20."

²³ "In relation to micro-prudential supervision and up till 2010, there were three financial services committees for micro-financial supervision (supervision of individual financial institutions) at EU level, with advisory powers only: the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR)." see European Commission, "Financial Supervision: Additional Legislative Proposals (January 2011) <http://ec.europa.eu/internal_market/finances/committees/index_en.htm>.

²⁴ See ibid. The ESAs, which replace the former European Committees for the banking, securities and insurance and occupational pensions sectors, are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). In cooperation and coordination with nationally-based supervisors, the ESAs are in place to ensure that rules are applied in a rigorous and consistent fashion throughout the European Union, to monitor developments within the financial system as well as to detect potential risks to financial stability.

The trio of new ESAs have taken over all of the functions of the previous committees, and in addition have certain additional competences, including the following:

- developing proposals for technical standards to better define common standards for the application of legislative acts, respecting better regulation principles;resolving cases of disagreement between national supervisors, where legislation requires them to cooperate or to agree;contributing to ensuring consistent
In line with measures aimed at mitigating procyclicality and its facilitation of forward-looking provisioning, the Basel Committee is supporting a move towards an expected loss approach in accounting standards - this being in line with risk management considerations that suggest that “loan-loss provisions should be forward looking.” This approach is contrasted to accounting standards, and particularly IAS 39, which traditionally require banks to provision based on specific “incurred loss” not expected loss. Further, it is added that whilst the adoption of international accounting standards contributes to financial stability by limiting the scope for arbitrary earnings manipulation, in a number of cases it has implied lower loan-loss provisioning than many supervisors would have considered prudent during the expansion phase of the cycle.

F. Conclusion: Further Issues to Be Addressed

Harmonising Views Relating to Accounting and Regulatory Definitions

1) Expected Losses and Non Expected Losses:

Capital constitutes a means of addressing expected losses – as well as recent initiatives undertaken by the Basel Committee to focus on buffers.

According to Laeven and Majnoni, regulatory capital, “should cope with the occurrence of unexpected losses – that is, losses that are large but infrequent and further, loan loss reserves should, instead, cope with expected losses.” In reconciling the different views held about bank capital requirements, they propose a partitioning of regulatory capital which is based not only on terms relating to priority (as is the case for Tier One and Tier Two Capital), but also (and foremost) on risk management considerations.

2) Addressing weaknesses in existing macro prudential arrangements

Recent initiatives aimed at fostering financial stability (as evidenced by steps taken in the UK) have resulted in the macroprudential supervisory function being transferred to the central bank. The Financial Services Authority is considered to have been endowed with adequate mechanisms of accountability. It will be quite interesting to see how the new prudential financial services regulator operates as a subsidiary of the Bank of England.

The relationship between micro and micro supervisors, it is argued, „must be articulated through a management by exception system involving direct authority of the macro supervisor over enforcement and allocation of tasks.“

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25 “That is, take into account expected credit losses over the medium term „ See R Moreno, Policymaking from a macro prudential perspective BIS Working Paper No 336, January 2011 at page 13 of 24
26 ibid
27 ibid
28 See L Laeven and G Majnoni, „Loan Loss Provisioning and Economic Slowdowns: Too Much, Too Late? at page 6
29 ibid
31 RM Lastra and L Garicano, „Towards a New Architecture for Financial Stability: Seven Principles“ Journal of
At supra national level and as is the case with the harmonisation of accounting and auditing standards, the EU faces a daunting task in respect of supervision and harmonisation. In response to the difficulties presented by convergence, the vital role it assumes in the standard setting process, and given the fact that it is considered by some to be an unfeasible objective, calls have been made for a re-think of the way in which it is implemented.\footnote{International Economic Law 13(3) at page 597}

3) Enforcement

As recently acknowledged by the Basel Committee,\footnote{In order to achieve this goal, the Committee will also be making efforts to conduct follow up and peer reviews whose areas of focus will include the common interpreting of standards and potential sources of regulatory arbitrage. See Basel Committee on Banking Supervision, „Basel III and Beyond“ and Remarks of Nout Wellink, Chairman, Basel Committee on Banking Supervision and President, De Nederlandsche Bank in relation to the conference High Level Meeting on Better Supervision and Better Banking in a Post-crisis Era, FSI and EMEAP Working Group on Banking (hosted by Bank Negara Malaysia) on the 17th January 2011 <http://www.bis.org/speeches/sp110118.pdf>}

„better and more intrusive supervision at the global level“, as well as the implementation of stronger mechanisms aimed at ensuring that the execution of standards and regulations established by the Committee and approved by the G20, are successfully enforced, constitute some of the efforts which have been undertaken and which need to be undertaken, if enforcement is to be facilitated.

Why should differences between regulatory and accounting policies be mitigated? Because mitigating such differences could facilitate convergence – as well as financial stability. A greater degree of oversight by the State in respect of its regulation of accountancy bodies (and the accountancy profession - as opposed to a system where self regulation of the accountancy bodies predominantly exists), as well as greater collaboration between international standard setters such as the IASB, FASB and the Basel Committee on Banking Supervision, would also facilitate the convergence of accounting, auditing and regulatory policies.
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APPENDIX

(In relation to the entire text and diagrams within this section/appendix, see pages 4-8, Impact Assessment Report of the:
Commission Staff Working Document Accompanying Document to the Proposal for a Regulation of the European Parliament and the Council on macro prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB)

http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/20090923_impact_en.pdf)

Regarding micro-prudential supervision, the problems identified in the first Impact Assessment can be summarised as follows:

- **Imbalance of interests of the home and host countries in the current supervisory model** (resulting in a misalignment of incentives in particular in cross-border crisis management),
- **Risks of competitive distortions in the Internal Market and of regulatory arbitrage by financial institutions** (arising in part from differing supervisory rules and practices),
- **Insufficient co-operation and information exchange between national supervisors,**
- **Excessive costs and administrative burden to cross-border companies due to fragmented and inconsistent financial supervision.**

**Figure 1 Problem Tree Micro Prudential Supervision** (see page 5 of the Impact Assessment Report)
The preferred solution for addressing these problems was to create a European System of Financial Supervision, comprising three European Supervisory Authorities, building on the existing Level 3 committees but with extended powers. This is not creating bodies from scratch, as is the case for the ESRB, but it is nevertheless an important evolution. In implementing this preferred option, a number of specific problems need to be addressed. The new bodies must be in a position to ensure greater coherence of supervision across EU Member States, via all of their interventions, both legally-binding and non-legally binding ones. They must also have a structure which ensures that the powers will be used in an appropriate manner. The budgetary needs of the new Authorities will be greater than the Level 3 committees, if only because the additional powers will require more staff. Specific issues to be tackled include the following:

- **Technical standards:** despite the efforts and progress achieved by the current level 3 committees, the prudential legislative framework has not yet attained the desired level of harmonisation and consistent application of rules in the EU. Ensuring a single set of harmonised rules is an ambitious objective which requires establishing new mechanisms that may help accelerate this process. Indeed, the current financial supervisory framework has been a good starting point but there is now a firm determination to move forward and reach a higher degree of consistency than the one achieved so far. To contribute to this, the Authorities will, in areas to be specified in the relevant sectoral legislation, develop draft technical standards. These standards constitute an effective instrument to strengthen Level 3 of the Lamfalussy structure, which is currently limited to the adoption of non-binding guidelines;
• **Colleges of supervisors:** one issue is to ensure the adequate functioning of colleges, particularly in terms of balancing the flow of information between home and host authorities. Another issue is to strengthen cooperation and facilitate joint decision-making between members of colleges.

• **Emergency situations:** there is a clear need for increased coordination between national supervisory authorities, in particular in case of adverse developments which potentially jeopardise the orderly functioning and integrity of the financial system in the EU. However, in some emergency situations, coordination may not be sufficient, notably when national supervisors alone lack the tools to respond rapidly to an emerging cross-border crisis. The new Authorities should therefore, in such exceptional circumstances, have the power to require national supervisors to jointly take specific action.

• **Impingement of Member States’ fiscal responsibility:** the Member States have decided that decisions taken by the ESAs cannot impinge on their fiscal responsibilities. This decision ensures that the principle of subsidiarity is respected, because the area of direct taxation is an exclusive competence of the Member States, and EU bodies cannot exercise any competences in that area. This limitation on the ESAs’ activity potentially concerns decisions settling disagreements between national supervisors and decisions taken in emergency situations. The problem is to implement this limitation on the ESAs' powers in an effective way, while not hindering the activity of the ESAs in areas which do not impinge on the fiscal responsibilities of Member States.

Regarding macro-prudential supervision, the problems identified in the first Impact Assessment can be summarised as follows:

• **Lack of appropriate analysis of macro-prudential risks at EU level, including risks stemming from macro-economic imbalances.** Currently, there is no EU body entrusted with this role;

• **Lack of interaction between micro- and macro-prudential analysis.** The soundness of individual firms was often supervised in isolation and there was little or no awareness of the degree of “interdependence” or “interconnectedness”;

• **Lack of adequate corrective action, cooperation and co-ordination by competent authorities during the building up and in the course of financial crisis.**
Figure 2: Problem Tree Macro Prudential Supervision

- The warnings and recommendations of the ESRB must reach the right addressees and lead to the desired action, but without having the counter-productive effect of helping to trigger a crisis by being self-fulfilling through the reaction which they provoke.
- The issue of information needs is also a key one, as the ESRB will only be effective if it receives the information which it needs in order to carry out macro-prudential assessments effectively.
- The ESRB must have a secretariat so structured and located as to allow it to carry out its functions effectively and with a minimum cost.
- Subsidiarity must be respected in the structuring and activity of the ESRB, in matters such as the representation of Member States and other parties on the Board, decision-making procedures, and follow-up to warnings and recommendations.
In determining a solution for addressing these problems, the first Impact Assessment took as its baseline scenario the EU retaining its fragmented approach to macro-prudential oversight, without introducing a mechanism for formally issuing and ensuring follow-up to warnings and recommendations. It analysed a range of possible options for developing a macro-prudential body, including building on existing structures using either the Economic and Financial Committee (EFC) or the European System of Central Banks (ESCB) or using the new microprudential structure (ESFS) by giving the leading role in macro-prudential supervision to the new Authorities with the support of the network of national supervisors. The analysis concluded that, on balance, a new body (the ESRB) should attain high level of effectiveness and provide for an adequate level of legitimacy. The envisaged architecture, status and operating procedures should allow this body to meet the objectives of efficiency, effectiveness and value for money in the most appropriate way. Having sole responsibility for macro-prudential risk warnings and an appropriate composition (bringing together the ECB, the national central banks, the new Supervisory Authorities as well as national supervisory authorities) would create valuable synergies, ensure an appropriate level of representation, and have a mutually reinforcing impact on the stability of the financial system.

In implementing this preferred option, a number of specific problems need to be addressed with regard to the ESRB. A new body is being created, with no precedents. The challenge is to create the body in such a way that its powers are appropriate for the tasks which it must carry out, namely that of analysing macro-economic risk and warning of potential systemic risks. Specific elements to be dealt with or taken into account include the following:

- The ESRB cannot be given binding powers unless it has legal personality, but despite this it must be as effective as possible in preventing financial crises.