Designing a Financial Stability Architecture for a Regionally Integrated Financial Space: The European Experience.

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(Gregor C Heinrich)*

Abstract

Any discussion on improving the existing arrangements for assessing and managing financial risks and in particular supervising the relevant institutions will also need to address the question on which institution should be responsible for which task and for which sector of the financial system, how these institutions should be organized and, if there are several, how they should interact with each other.

Based on the example of the European Union, this paper shows the gradual change from a rather loose rather idealistic cooperative framework among entirely independent institutions, over the right to contribute to the functioning of policies set by others, on to the Single Supervisory Mechanism, a centralized structure in which – at least for the banking sector - the ECB takes on a rather powerful role of policy making, oversight and enforcement.

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Designing a Financial Stability Architecture for a Regionally Integrated Financial Space: The European Experience

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Any discussion on improving the existing arrangements for assessing and managing financial risks and in particular supervising the relevant institutions will also need to address the question on which institution should be responsible for which task and for which sector of the financial system, how these institutions should be organized and, if there are several, how they should interact with each other.

This can already be a challenging issue in a merely national context. It is even more so in an international, transnational or regional context.

In Europe, the launch of the so-called Banking Union on June 29, 2012, was arguably the European Union's most consequential policy initiative since the start of its financial crisis in mid-2007.

Interconnectedness of financial activity and financial institutions, another topic of this conference, obviously generates the question whether supervision can be left as hitherto to national institutions that at best cooperate with each other and exchange information on the basis of MoUs, or whether a different framework might better be suited to face and manage the existing cross border challenges.

In the Caribbean there is a certain interest in knowing about the European experience in designing a financial stability architecture, as the European Union is in some way a group of countries that are increasingly integrated at the economic, monetary, trade and infrastructure levels.

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While there are some things that seem to be in common, there are also many differences that would probably require a more differentiated approach.

In this presentation I plan to

I. Highlight some of the commonalities and differences between the two regions

II. Offer an overview of the various steps that led to the current European arrangements.

III. And offer some examples of ongoing challenges.

I. The Caribbean and the EU - Commonalities and differences

The Caribbean has, in the form of the Caribbean Community (CARICOM), and the Caribbean Common Market, both founded in 1973[1], a framework that aims to achieve improvements in trade, production, competitiveness and also enhanced functional cooperation in areas such as health, communications, technological developments, etc. But its objectives do not – at the moment at least – mention economic policy, financial services or financial stability.

In contrast, the European Union treaty (and its predecessor, the Treaty on the European Community) clearly state as one the activities the adoption of a common economic policy and the definition and conduct of a single monetary policy and exchange-rate policy. And the European Union Treaty then created the European System of Central Banks and the ECB, and single currency, the euro.

At this time, the Caribbean countries do not have a single common currency a Caribbean System of Central Banks or a single central bank (with the exception of the countries that share the Eastern Caribbean central bank).

It does not - yet - have a shared safety net in the form of a joint deposit insurance scheme or single resolution fund – but neither does the European Union, even though it is working on it in the framework of the so-called Banking Union.

As regards financial infrastructure, the EU does have a common payment system across national borders in the EU in form of the TARGET platform[2] for Eurosystem banks, and the ECB performs its payment system oversight tasks[3] on the basis of the standards and recommendations it has developed by itself or else in cooperation with other central banks and authorities. Standards and recommendations are harmonised, and systematic oversight of payment; clearing and securities settlement make it easier to compare assessments of different systems.

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1 The Treaty of Chaguaramas which established the Caribbean Community including the Caribbean Common Market was signed by Barbados, Guyana, Jamaica and Trinidad and Tobago on 4th July, 1973, in Chaguaramas, Trinidad and Tobago. It came into effect on 1 August 1973. Revised Treaty of Chaguaramas establishing the Caribbean Community including the CARICOM Single Market and Economy, http://www.caricom.org

2 https://www.ecb.europa.eu/paym/t2/about/vision/html/index.en.html. On transaction volumes (also of other payment and settlement systems in Europe see CPMI (2014).

3 See for instance ECB (2015).

Without a common currency in the Caribbean, it is understandable that there is also not yet a joint payment system or a formal joint payment system oversight structure.[4]

On the other hand, the Caribbean does have the oldest regional network of bank supervisors in the world, the Caribbean Group of Banking Supervisors (CGBS)[5], established 1983.

It has the specific mandate to enhance and coordinate the harmonization of the bank supervisory practices in the English speaking Caribbean, with a view to bringing them in line with internationally accepted practices.

As far as I can tell, the CGBS does share some guidelines or handbooks of their members, the Group does not yet seem to elaborate or enforce a joint governance structure, regulation or supervision.

As regards the private sector self-organisation, Europe has its influential European Banking Federation (EBF)[6]; in the Caribbean, the Caribbean Association of Banks (CAB) is a common platform that seeks to influence regional financial service policies.[7]

Caribbean countries, at least the English-speaking ones, also have one advantage over European Union countries: they share a common language, a common legal tradition and there are fairly large similarities in cultural heritage. This could actually be very helpful in strengthening a cooperative framework in the region.

Finally, but that will come as no surprise to you there are enormous differences in the financial size of the overall financial market or institutions in the EU as compared to the Caribbean. But both Europe and the Caribbean host internationally active institutions, and in the Caribbean, financial conglomerates and other institutions with complex ownership structures tend to control a large market share simultaneously in several countries of the region.[8] And, as an IMF study of 2013 highlighted, the relative size of the sector in the Caribbean could be a source of risk and concern:[9]

II. Developing a European Financial Architecture

But now allow me to offer an overview of the various steps that led to the current European Financial Architecture and the motivation behind these steps

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4 Heinrich (2007).

5 http://www.cgbsnet.org

6 http://www.ebf-fbe.eu

7 http://www.caibinc.info/about_us

8 Ogawa, Park, et al (2013).

9 Ogawa, Park, et al, (2013): “The financial sector in the Caribbean is large relative to the size of the economies and dominated by banks, although non-bank financial institutions (NBFIs) are becoming important. The total assets of the financial sector, excluding offshore banks, amount to 124 percent of the regional GDP, with the banking system accounting for some 91 percent and non-bank financial institutions such as credit unions and insurance companies accounting for the rest. The Bahamas and Barbados have significant offshore banking sectors, equivalent to 72 times and 11 times their respective economies, far outstripping the size of the onshore sector.”

Like many reforms, the reforms that led to the current structure of European financial architecture have its origins in crises.

Crises have one big advantage: they spur creative thinking, at least for a while, make those affected huddle together and offer motivation to find a solution that will hopefully prevent a next crisis, or at least make the next crisis less costly for the society as a whole.

The last worldwide financial crisis comes of course to mind when we think about incentives to strengthen financial stability, in particular at the level of the G20 countries via the Financial Stability Board. And in the Caribbean, I would say, the collapse of the CL Financial Group[10] was also an event that triggered thinking of whether something can be done to prevent similar events in the future.

Not only a crisis can provoke new thinking. Also a major change in underlying structures can result in the need to find new rules, regulations and even institutional arrangements.

In the Caribbean for instance this has happened when countries became independent, in Europe, a strong incentive – actually a need - to change structures came with the introduction of the euro as a common currency for most countries of the European Union.

In Europe, the crisis exposed fault lines in governance, and deficiencies in the architecture of the financial supervisory and regulatory framework. In particular, momentous events such as the freezing of interbank markets, the loss of confidence in financial institutions, runs on banks and difficulties affecting cross-border financial groups, questioned the ability of the EU financial stability architecture to contain threats to the integrated single financial market. The need for more effective micro and macro-prudential regulation and supervision, but also for better coordination between the two as well as amongst regulators, was underscored. The crisis has also confirmed that central banks can play an important role in safeguarding financial stability.

The crisis has prompted critical thinking about the EU economic and financial policy frameworks and the need for a new supervisory architecture and indeed the need for a comprehensive crisis management regime. Not that this was not understood earlier.

The lack of harmonisation in the European legal and supervisory framework and its potential cost in managing crises were known.[11]

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[10] In particular, the insurance sector was affected by the collapse of the CL Financial Group, the largest insurance company in the region. This group's total assets were estimated at about US$16 billion, equivalent to around 30 percent of the Caribbean region's GDP, operating in at least 28 countries. CL Financial was regarded as a successful example of financial integration of companies within the region. Weak corporate governance, high interest rate annuity products with corresponding high risk investments, and high leverage led to the collapse of the group, bringing significant spillover effects to the Caribbean region; Ogawa, Park et al (2013) p. 13.

[11] See Recine/Teixeira (2009).

But we need to step back even further, as there were reforms of the institutional architecture of financial regulation and supervision also before the recent financial crisis. At the risk of not entering into all details or covering all sectors of the financial system, a chronological overview might be of help.

It will show the gradual change from a rather loose rather idealistic cooperative framework among entirely independent institutions, over the right to contribute to the functioning of policies set by others, on to the Single Supervisory Mechanism, a centralized structure in which – at least for the banking sector - the ECB takes on a rather powerful role of policy making, oversight and enforcement.

1) 1985 Commission White Paper

In June 1985 the Commission presented a rather short document to the Council, highlighting steps that would be needed to complete the internal market. The document focused on three main areas: the removal of physical barriers, the removal of technical barriers, the removal of fiscal barriers, and a timetable to complete these steps by 1992.

The interesting part for us is that as part of the removal of technical barriers, it mentions a common market for financial services, thus introducing the single market approach to financial services as well as introducing the concept of “home country control”.[12]

At the time there was no talk of strong harmonisation of surveillance standards, institutional linkages and even less of a centralised authority.

The report states, for instance (emphasis added):

> “The Commission considers that it should be possible to facilitate the exchange of such financial products at a Community level, using a **minimal coordination** of rules (especially on such matters as authorisation; financial supervision and reorganisation winding up, etc.) as the basis for mutual recognition by Member States of what each does to safeguard the interests of the public”

And:

> “Such harmonisation particularly as regards the supervision of ongoing activities should be guided by the principle **of "home country control".** This means attributing the primary task of supervising the financial institution to the competent authorities of its Member State of origin to which would have to be communicated all information necessary for supervision. The authorities, of the Member State, which is the destination of the service, whilst not deprived of all power, would have a complementary role. There would have to be a **minimum harmonisation** of surveillance standards, though the need to reach agreement on this must not be allowed further to delay the necessary and overdue decisions.”

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12 European Commission (1985).

2) 1989 – Delors Report

In April 1989 a committee of experts under the chairmanship of Jacques Delors presented their Report [13] under the mandate of the European Council "to study and propose concrete stages "leading towards economic and monetary union" in the European Community. The report laid the groundwork amongst other for the upcoming monetary union and also highlighted some interesting challenges that would eventually be solved only by creating a centralised institution.

For instance:

> "Well before the decision to fix exchange rates permanently, the full liberalization of capital movements and financial market integration would have created a situation in which the coordination of monetary policy would have to be strengthened progressively. Once every banking institution in the Community is free to accept deposits from, and to grant loans to, any customer in the Community and in any of the national currencies, the large degree of territorial coincidence between a national central bank's area of jurisdiction, the area in which its currency is used and the area in which 'its' banking system operates will be lost.
>
> In these circumstances the effectiveness of national monetary policies will become increasingly dependent on cooperation among central banks. Indeed, the growing coordination of monetary policies will make a positive contribution to financial market integration and will help central banks gain the experience that would be necessary to move to a single monetary policy."

The Report also addresses institutional arrangements. Evidently, a new monetary institution would be needed because a single monetary policy cannot result from independent decisions and actions by different central banks. The report suggested that the domestic and international monetary policy making of the Community should be organised in a federal form: the European System of Central Banks (ESCB), consisting of a central institution and the national central banks.

One of the functions of the new ESCB, apart from commitment to price-stability, and the responsibility for the formulation and implementation of monetary policy, was that:

> "…the System would participate in the coordination of banking supervision policies of the supervisory authorities."

So at the time no more than a participation in the coordination of supervisory policies was foreseen, and the supervisory authorities were still seen as very separate entities. In fact, the Report does not really address issues of banking supervision or financial stability.

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[13] Delors, J. (1989).

3) 1992 Maastricht Treaty

The main recommendations of the Delors Report were agreed in the Maastricht Treaty (formally the "Treaty on European Union"), signed on 7 February 1992, and entered into force on 1 November 1999.[14]

The Treaty addressed many issues relating to the existing treaties of the European Community but the most important – with regard to today's conference - were the rules that set out the framework for the European Monetary Union and single currency, including the European Monetary Institute, the European System of Central Banks and the ECB.

The Treaty also contained some provisions, which, in hindsight show how national governments wished to keep some control over financial institutions and their supervision.

While on the one hand the Treaty prohibited all restrictions on the movement of capital between Member States (and between Member states and third countries) and also prohibited any restrictions on payments (Article 73 b), it did allow for Member states to take measures that would prevent infringements on national law and regulations in the field of prudential supervision of financial institutions (Art 73 d).

But it does give the ESCB the authority to at least

> "Contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

This was rather a consulting role and the rule making and surveillance authority clearly remained with national authorities. However, the Treaty also laid some groundwork for a stronger involvement of the ECB in prudential supervision, albeit not without requiring the passing of several hurdles (Art 105, 6).

> "The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings ".

Another interesting part of the Treaty is that it addresses, for the first time in the process, as far as I can tell, financial stability. A section in the Protocol on the ESCB mentions that the ESCB shall contribute not only to the smooth conduct of policies

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14 Original text: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:C:1992:191:TOC, consolidated Version 2012: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012M/TXT&from=EN.
Entry into force of Maastricht Treaty: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_1993_293_R_0061_063&rid=1

relating to the supervision of credit institutions by the competent national authorities but the ESCB shall also contribute to the stability of the financial system. [15]

4) 1999 – introduction of the euro and subsequent architecture reports

a) Euro introduction - 1999

The euro, as you know, came into force on 1 January 1999, first as an accounting currency, while physical euro coins and banknotes entered into circulation on 1 January 2002.

After the introduction of the euro in 1999, the debate on the financial stability architecture in the EU focused on the adequacy of a decentralised setting based on national responsibilities for preventing and managing crises.

The Financial Services Action Plan in 1999[16] and the introduction of the Lamfalussy process for financial regulation and supervision in 2001[17] enhanced the decentralised arrangements by increasing significantly the level of legal harmonisation and supervisory cooperation.

In addition, authorities adopted EU-wide Memorandums of Understanding (MoUs) to safeguard cross-border financial stability.

b) Financial Services Action Plan (FSAP) – 1999

Originally adopted in 1999, the FSAP was an ambitious programme touching upon securities, the pension sector, the insurance sector, mortgages, and banking (including anti money-laundering initiatives).

It had four key strategic objectives:

- developing a single European market in wholesale financial services;
- creating open and secure retail markets;
- ensuring financial stability through establishing state of the art prudential rules and supervision; and

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15 Art 3.3, PROTOCOL, on the Statute of the European System of Central Banks and of the European Central Bank

16 http://ec.europa.eu/internal_market/finances/policy/archive_en.htm#fsap; http://ec.europa.eu/finance/general-policy/actionplan/index_en.htm

See also the study "Evaluation of the economic impacts of the Financial Services Action Plan, March 2009, http://ec.europa.eu/internal_market/finances/docs/actionplan/index/090707_economic_impact_en, and the study on the cost of compliance with selected FSAP measures, http://ec.europa.eu/internal_market/finances/docs/actionplan/index/090707_cost_of_compliance_en.pdf, and

17 Final report of the Committee of Wise Men on the regulation of securities markets, 15.2.2001, http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf.

- setting wider conditions for an optimal single financial market.

To meet these four strategic objectives, the FSAP introduced 42 measures each with their own operational objectives (such as increasing market confidence, harmonising information etc.).[18]

The measures also included strengthening the rules on prudential supervision. Interestingly, these measures were based in part on the shortcomings of "Basel I", mainly its lack of risk sensitivity – shortcomings that were then also the focus of the so-called Basel II and more recently Basel II[19]I efforts.

The FSAP also mentioned the importance of ensuring the continued stability of EU financial markets.

It made it clear that regulatory safeguards need to keep pace with new sources of financial risk and state-of the-art supervisory practice in order to contain systemic or institutional risk (e.g. capital adequacy, solvency margins for insurance) and take account of changing market realities (where institutions are organised on a pan-European, cross-sectorial basis).

Suggested measures include:[20]

- moves to bring banking, insurance and securities prudential legislation up to the highest standards, taking account of the work of existing bodies such as the Basle Committee and FESCO - Forum of European Securities Commissions (adoption of proposed Directives on winding-up and liquidation of banks and in-

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18 There are several Directives, communications, recommendations and regulations related to the banking industry in the FSAP. These include:

- Recommendation 2001/193 (C(2001)447) on pre-contractual information to be given to consumers by lenders offering home loans;
- COM(2000)36 and COM(2003)718 on retail payments and a new legal framework for payments in the Internal Market;
- Regulation 2560/2001 on cross-border payments in euro;
- Directive 2001/24/EC on the reorganisation and winding up of credit institutions;
- Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions (E-Money Directive);
- Directive 2001/97/EC amending Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering – Commission Declaration (2nd Money Laundering Directive);
- Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast) (CRD);
- Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Financial Conglomerates Directive); and
- Directive 2003/48/EC on taxation of savings income in the form of interest payments (Savings Tax Directive).

19 www.bis.org/bcbs; http://www.bis.org/bcbs/basel3.htm;

20 http://europa.eu/rapid/press-release_IP-99-327_en.htm?locale=en

surance companies and on electronic money, amendment to the money laundering Directive, proposals to amend capital framework for banks and investment firms and amend solvency margins for insurance companies)

- work on prudential supervision of financial conglomerates (proposal for Directive)
- arrangements to increase cross-sectoral discussion and cooperation between authorities on issues of common concern (creation of a Securities Advisory Committee).

The latter point is of interest, as among the identified shortcomings was:[21]

- Absence of requirement for supervisory cooperation:
    - in an increasingly cross-border market authorities must cooperate effectively with each other in the supervision of cross-border groups to reduce regulatory burdens; and
- Absence of proper market disclosures:
    - the previous Directives do not facilitate effective market discipline through provision of reliable information for market participants to make well-founded assessments.

The old EU system thus lacked the flexibility to keep pace with rapid developments in financial markets and risk management practices, and with improvements in regulatory and supervisory tools.

Regulatory failure due to the increasingly obsolete nature of Basel 1 was increasingly possible.

While as result of the FSAP cooperation and exchange of information was strengthened, and rules were further harmonized, no fundamental changes were made in the governance – or architecture of the framework to strengthen financial stability

c) Lamfalussy Report – 2001

Also the so-called Lamfalussy Report of 2001,[22] aimed at strengthening securities markets in Europe, recommended strengthening cooperation between financial market regulators. Interestingly it also recommends including in the cooperation the institutions in charge of micro and macro supervision and cross-sectoral regulators. And it proposed to create a structure with various bodies at different levels, each responsible for a concrete task in the process of regulating the securities markets.

This in turn would require action by Economic and Finance Committee, European Central Bank and national central banks, European Commission, European Parliament, Member States and European regulators.

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21 European Commission (2004).

22 Above, footnote 17.

d) A first series of reform steps

Indeed, the actions and reports mentioned above resulted in a number of important reform packages:

In Dec 2002 – ECOFIN, the Economic and Financial Affairs Council[23], published a reform of the institutional architecture of financial regulation and supervision in the EU.[24]

The main aim of this reform — which followed a similar reform conducted in the field of the securities markets — is to solve the problems that have been experienced with the EU legislative process in the past. The reform tried to adapt the Lamfalussy recommendations report to the banking market and introduced a sectoral and decentralised model of financial regulation and supervision, which is neutral as concerns the institutional arrangements of such functions at national level and was to ensure the cooperation between the national regulators and supervisors of financial markets across countries.

One needs to be aware that the complexity of the structure is also due to the fact that each member state had, and still has, different models of institutional organization and distinct degrees of participation by central banks in these tasks in the case of euro area countries.

In this debate, the European Central Bank favoured an institutional framework in which the exercise of monetary policy in the euro area is accompanied by strong responsibility on the part of national central banks in relation to the task of banking supervision as well as by strengthened cooperation among countries in this area.

From the perspective of the European Central Bank, the attribution of ample supervisory responsibility (in both macro- and microprudential supervision contexts) to central banks in the euro area, with the scope extending beyond banking, was considered desirable from two points of view:[25]

Above all it allowed banking supervisors (central banks and/or agencies) to use their network of contacts in order to better assess potential systemic risks, and secondly, to make possible a closer implicit coordination with the monetary policy function. Against this background, the European Central Bank has defined financial stability

> "…as a condition in which the financial system would be able to withstand shocks, without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payments in the economy". [26]

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23 ECOFIN is one of the oldest configurations of the Council of the European Union; it is made up of the economics and finance ministers of all the 28 union member states. The Council is responsible for EU policy in economic policy, taxation issues and the regulation of financial services; http://www.consilium.europa.eu/en/council-eu/configurations/ecofin/

24 See "Nieto/Peñalosa (2004).

25 Nieto/Peñalosa (2004).

26 Padoa-Schioppa (2002).

The "European regulatory system for the singe financial market" entailed no transfer of supervisory authority to the Community; rather it created a network of Committee structures.

The Lamfalussy committee-structure for financial regulation and supervision.[27]

	Banking	Insurance and pensions	Securities
Regulatory committees (Level 2)	European Banking Committee (EBC)	European Insurance and Occupational Pensions Committee (EIOPC)	European Securities Committee (ESC)
Committee of supervisors (Level 3)	Committee of European Banking Supervisors (CEBS) (London)	Committee on European Insurance and Occupational Pension Supervisors (CEIPOS) (Frankfurt)	Committee of European Securities Regulators (CESR) (Paris)

The Committee of European Banking Supervisors (CEBS) was established in 2004, it was composed of senior representatives of bank supervisory authorities and central banks of the European Union. It acted as independent body in charge of advising and coordinating on banking regulation and supervision in the European Union (EU). It was replaced in 2011 by the European Banking Authority[28] as part of the European System of Financial Supervision (ESFS), but more on that later.

Committees are of course a well-established way to recognize and maintain the authority, sovereignty, independence and at times very different cultural, legislative and institutional background of the individual constituents; but decision making can be slow and cumbersome. While Committees are a reasonably good structure for information exchange and the preparation of rules that require a broad consensus, the structure may perhaps not be ideal if decisions need to be taken in a crisis situation.

e) Memorandum of understanding (2003, 2005, 2008)

The institutions tried do overcome shortfalls of such a relatively loose Committee structure with the "Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations", published on 18 May 2005 that entered into force on 1 July 2005.[29] An earlier MoU was published in 2003, but that one did not involve Finance Ministers.[30]

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27 From: Recine/Teixeira (2009)

28 www.eba.europa.eu

29 Press release: http://www.ecb.europa.eu/press/pr/date/2005/html/pr050518_1.en.html, and https://www.eba.europa.eu/-/memorandum-of-understanding-on-co-operation-in-financial-crisis-situations .

30 "Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations", 10 March 2003; press release: http://www.ecb.europa.eu/press/pr/date/2003/html/pr030310_3.en.html

The MoU – which is not a public document - set forth practical arrangements aimed at promoting co-operation between authorities in crisis or potential crisis situations without overriding their respective institutional responsibilities or restricting their capacity for independent and timely decision-making in their respective fields of competence, notably with regard to the conduct of day-to-day central banking and supervisory tasks, as set out in national and Community legislation.

So again, national competence was not touched. Furthermore, while such a MoU was an important step forward, it was nevertheless a non-legally binding instrument.

5) The financial crisis 2007/2008

Genuine structural changes came about only in the aftermath of the recent financial crisis.

The financial crisis started in Europe in 2007 with first reported sub-prime related losses and then in August 2007 the freezing of interbank markets. In June 2008 there was yet another MoU, as mentioned above, on cross-border financial stability, and in September 2008, Lehman Brothers filed for bankruptcy.

The financial crisis as from 2007/08 challenged fundamental assumptions regarding the functioning and expansion of the single financial market. [31]

It highlighted in particular the so-called "trilemma of financial stability" according to which (1) a stable financial system, (2) an integrated financial system and (3) national financial autonomy are incompatible. Any two of the three objectives can be combined but not all three; one has to give. [32]

The single banking market was built on the premise that banks conduct the majority of their business at home and only branch out to other EU countries on a modest scale. This premise is no longer true. Already in 2009, some of the major European banks such as Deutsche Bank, BNP Paribas and UniCredit conducted more business cross-border than at home.

The single market in a way became weighed down by its own success The incompatibility - within the financial stability trilemma - derives basically from the fact that the single financial market was constructed in a setting where market integration is managed on the basis of home- host-country relationships and where the economic benefits of integration are spread and shared among Member States.

Conversely the common economic risks stemming from the increased financial integration are not mutualised but rather dealt with on the basis of national responsi-bilities, as long as regulators and governments remain only accountable to national parliaments and taxpayers.

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31 See "Driving European Recovery", communication for the Spring European Council, 4.3.2009, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:PDF

32 Schoenmaker (2009) and (2011) See also Schoenmaker/Osterloo (2014).

In this context, the financial crisis has proved to be a major challenge to the ongoing process of European financial integration. In particular, the crisis has demonstrated the importance of an effective macro-prudential supervision, aimed at a broad and effective monitoring and assessment of the potential risks covering all components of the financial system.[33]

6) de Larosière Report – 2009 and its impact

These needs for reform became documented in particular after European Commission President Barroso conferred a mandate to Jacques de Larosière in October 2008 to chair an outstanding group of people to give advice on the future of European financial regulation and supervision, and to consider how the European supervisory arrangements could be strengthened both to better protect its citizens and to rebuild trust in the financial system.

The sequence of steps undertaken in that period was surprisingly fast.

The report, known as the De Larosière Report was finished in February and published in March 2009.[34]

A few days later, the Commission issued on the one hand a Communication on "Driving European recovery"[35], and in parallel started a public consultation process on the future of financial services supervision in the EU[36] and, still in March, organised an international conference on a new supervisory architecture[37].

And on 27 May 2009 the Commission published the roadmap for a new supervisory framework for the EU.[38]

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33 Borio (2003): "The objective of a macroprudential approach is to limit the risk of episodes of financial distress with significant losses in terms of the real output for the economy as a whole. "

Borio (2014), "The macroprudential approach addresses the two drawbacks head-on by focusing on the system as a whole rather than on individual institutions - on the wood rather than the trees … The approach calibrates standards with respect to both the systemic footprint of individual institutions (the so-called "cross-sectional dimension") and the evolution of system-wide risk (the so-called "time dimension"). In so doing, it also addresses what has come to be known as the "procyclicality" of the financial system - those self-reinforcing processes that amplify financial booms and busts and are at the root of financial crises."

34 Report, The high-level group on financial supervision in the EU, Chaired by Jacques de Larosière, Brussels, 25.2.2009, http://ec.europa.eu/finance/general-policy/docs/de_larosiere_report_en.pdf

35 European Commission (2009).

36 Consultation period 10.3-10.42009; http://ec.europa.eu/internal_market/consultations/2009/fin_supervision_en.htm.; press release: http://europa.eu//rapid/press-release_IP-09-373_en.htm

37 "High-Level Conference «Towards a new supervisory architecture in Europe», Bruxelles, 7 May 2009; programme at http://ec.europa.eu/finance/general-policy/docs/committees/supervision/070509programme_en.pdf

38 "European financial supervision", Commission of the EU, 27.5.2009, COM(2009) 252 final; http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf

7) The European Systemic Risk Council (ESRC) and European System of Financial Supervisors (ESFS)

With its communication of May 2009, the European Commission accepted the main proposals of the de Larosière Report, namely to recommend the establishment a European System of Financial Supervision and a European Systemic Risk Board, the latter body to be set up under the auspices of the ECB.

a) ESRB

There are essentially two important new elements as regards the supervisory architecture. First, with creation of the European Systemic Risk Board (ESRB)[39] there is a new, centrally organised entity addressing macro-prudential issues, and second, the ESRB acts under the auspices of the ECB. The President of the ECB is Chairman of the Board and also chairs the Board's Steering Committee.

The role of the ESRB is to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole ("macro-prudential supervision").

To this end, the ESRB provides an early warning of system-wide risks that may be building up and, where necessary, issues recommendations for action to deal with these risks. The creation of the ESRB thus address one of the fundamental weaknesses highlighted by the crisis, which is the vulnerability of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks.

The legislation to establish the ESRB did not, however, enter into force until 16 December 2010 and the Board itself was established as from January 2011 and it published its first Annual Report in May 2012.[40]

In Practice, the Board does the following:

- collects and analyses all information relevant for monitoring and assessing potential threats to financial stability that arise from macro-economic developments and developments within the financial system as a whole;
- identifies and prioritises such risks;
- issue risk warnings where risks appear to be significant;
- where necessary gives recommendations on the measures to be taken in reaction to the risks identified;
- monitors the required follow-up to warnings and recommendations, and
- liaises effectively with the IMF, the FSB[41] and third country counterparts.

[39] The Commission communication called the entity European Systemic Risk Council (ESRC) and the current name was adopted later.

[40] https://www.esrb.europa.eu/pub/ar/html/index.en.html

[41] www.financialstabiltyboard.org

b) ESFS

With the European System of Financial Supervisors (ESFS), the EU created a formal network of national financial supervisors working in tandem with new European Supervisory Authorities ("ESAs") to safeguard financial soundness at the level of individual financial firms and protect consumers of financial services ("micro-prudential supervision").

The ESFS consists of three European Supervisory Authorities: a European Banking Authority (EBA)[42], a European Securities and Markets Authority, and a European Insurance and Occupational Pensions Authority

The new European network goes beyond mere coordination or information exchange and is being built on shared and mutually reinforcing responsibilities, combining nationally based supervision of firms with centralisation of specific tasks at the European level.

The hope is that this will not only foster harmonised rules but also a coherent supervisory practice and enforcement.

As the Commission pointed out in its document, the network should be based on the principles of partnership, flexibility and subsidiarity. It would aim to enhance trust between national supervisors by ensuring, inter alia, that host supervisors have an appropriate say in setting policies relating to financial stability and consumer protection, thereby allowing cross-border risks to be addressed more effectively.

As with the ESRB, the system became functional only once the required legislative steps were taken; the relevant text were published in December 2010, and the new authorities started to work on 1 January 2011.

One needs to be aware, though, that the ESAs do not have real enforcement powers. However, by mid-2014 around 150 technical standards proposals were submitted by all ESAs to the Commission, and the ESAs have been instrumental in conducting peer-reviews. However, their activities have been more regulatory than supervisory, and, while they have no direct enforcement powers and their Guidelines are mostly non-binding[43], the strongest tool at their disposal is "comply or explain".

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[42] https://www.eba.europa.eu. The European Banking Authority (EBA) is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking whose objective is to provide a single set of harmonised prudential rules for financial institutions throughout the EU. The Authority also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector.

[43] ESAs can issue binding decisions under Articles 17 to 19 ESAs Regulation (e.g. on breach of law, emergency situations, binding mediation).

8. Towards a Banking Union

The creation of the two bodies, the ESAs and the ESRB, is however not the end of the story. After all, as a result of the crisis that emerged in 2008, the Commission pursued a number of initiatives to create a safer and sounder financial sector for the single market.

In September 2012 Commission proposed a Single Supervisory Mechanism (SSM)[44] for banks led by the European Central Bank (ECB) in order to strengthen the Economic and Monetary Union.

The important additional step was that in September and October 2013 the EU formally adopted the creation of a bank Single Supervisory Mechanism that transferred certain supervisory powers directly to the ECB.[45] It de-facto created a new institution in the ECB, the Supervisory Board that is separated from the monetary policy function.

The set of proposals is a first step towards an integrated "Banking Union" which includes further components such as a single rulebook, common deposit protection and a single bank resolution mechanism. In detail, the proposals concern:

- *A regulation giving strong powers for the supervision of all banks in the euro area to the ECB and national supervisory authorities i.e. the creation of a single supervisory mechanism;*
- *A regulation with limited and specific changes to the regulation setting up the European Banking Authority (EBA) to ensure a balance in its decision making structures between the euro area and non-euro area Member States;*
- *A communication outlining the Commission's overall vision for rolling out the banking union, covering the single rulebook, common deposit protection and a single bank resolution*

The organisational structure of the ESRB and ESFS is thus only one of several elements.

The ECB now directly supervises the largest banks, and periodically the ECB now publishes a list of these institutions. In fact, the ECB now supervises more assets and more global systemically important institutions than any other regulator/supervisor in the world.

Under the SSM, the national supervisors continue to monitor the remaining, smaller and not systemically important banks. The main task of the ECB and the national supervisors, working closely together within an integrated system, is to check that banks comply with the EU banking rules and to tackle problems early on. The "ex ante" common supervisory procedures include bank authorisation, withdrawal of bank authorisation and assessment of the acquisition of a qualifying holding. The role

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[44] See instructive video by the ECB at https://www.youtube.com/watch?v=n2t0Wt9hGUc

[45] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. Available at http://bit.ly/1dJpPy9 .

of the national authorities in these procedures is limited to serving as an “entry point” (in the case of authorisations) or to initiating the procedure and consultations (in the case of withdrawals).[46]

Apart from the Chairman, the Supervisory Board of the SSM has four representatives from the ECB, one representative from each national supervisory authority, and a representative from the European Commission as observer. Simple majority takes decisions and only for the adoption of regulations a qualified majority is required.

The Single Resolution Mechanism (SRM) applies to banks covered by the SSM. In the cases when banks fail despite stronger supervision, the mechanism will allow bank resolution to be managed effectively through a Single Resolution Board[47] and a Single Resolution Fund, financed by the banking sector. It will however still take several years before the resolution fund will be fully financed and functional.[48]

The SRM’s is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy.

Finally, the Banking Union and the SSM also address the fact that during the financial crisis different countries applied different standards assessing banks. To ensure that the same rules are applied to all banks in the future, the new Single Supervisory Mechanism will rely on a set of rules, including capital requirements, depositor protection, and prevention and management of bank failures that are being brought together in the so-called “single rulebook”, the foundation on which the Banking Union sits.

<table>
<tr><td colspan="2" align="center">Banking Union</td></tr>
<tr><td align="center">Single Supervision</td><td align="center">Single Resolution</td></tr>
<tr><td colspan="2" align="center">Single Rulebook</td></tr>
</table>

Banking Union applies to countries in the euro-areas but other EU countries may join.

The Banking Union is an even more challenging tasks than the ones mentioned before, and setbacks can be foreseen in particular as regards a single resolution mechanism and a joint deposit-insurance scheme.[49]

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46 Nieto/Peñalosa, above, fn 24.

47 http://srb.europa.eu

48 The Single Resolution Fund was approved by the European Parliament on 15.4.2014 and 55bn euros will be financed in the course of the next 7 years. In December 2014, the Council of the EU reached a political on the bank contributions for such financing: Press Release ST 16645/14, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/146129.pdf See also Central Banking, “Europe’s banking union gets single resolution mechanism”, 20.3.2014; ACC, “Banking reform updater 11 - the single resolution mechanism examined”, 27.1.2015

49 For national view of the Banking Union, for instance Veron (2014).

III. Challenges – does the new architecture work?

We can see that in the last decades a multitude of reforms were implemented, each time introduced with the hope that they would work efficiently to ensure an adequate supervision of the financial system in the European context, only to be remodelled at the next signs of systemic tension.

So the question remains whether the new architecture has been successful so far in achieving the desired goals.

Obviously, the European authorities have an interest in this as well, not least as part of the accountability that any public institution should have vis-à-vis its constituents. But the regulations establishing the new European Supervisory Authorities and the ESRB include provisions to publish a general report on the experience acquired as a result of the operation within the ESFS and the ESFS as a whole.

A consultation was launched in April 2013 and the first review reports were published in August 2014.[50]

Overall, the report with respect to the ESAs mention that in spite of difficult circumstances the ESAs have quickly established well-functioning organisations. Overall they have performed well against their broad range of tasks, while facing increasing demands with limited human resources.

However, as can be expected, the reports did highlight several areas where further improvement is required, both in the short term as well as longer term. Some would require further legislative changes, others not.

A few of the suggested improvements are as follows.

1) Proposed improvements for the ESAs

- Increase focus on supervisory convergence could be increased in order to ensure the consistent implementation and application of EU law, in particular more and better use of peer reviews, and more systematic follow-up
- Enhance the transparency of the process for preparing draft technical standards or advising the Commission and ensure, where needed, high quality cost-benefit analysis
- Give consumer/investor protection tasks a higher priority and make full use of available powers.
- Enhance internal governance:
- Transparency of the work of the stakeholder groups could be strengthened.
- The role *and influence of ESA staff within preparatory bodies, such as working*.
- Direct access to data by ESAs and strengthening of role of Chair or Managing Board in that respect

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50 Report on ESAs, 8.8.2014, COM(2014) 509 final: http://ec.europa.eu/finance/general-policy/docs/committees/140808-esfs-review_en.pdf ; Report on ESRB: 8.8.2014, http://ec.europa.eu/economy_finance/articles/governance/pdf/2014-08-08_esrb_review_en.pdf

- Duration of mandates of stakeholder groups

2) Proposed improvements for the ESRB

As regards the ESRB one needs to be aware that macro-prudential supervision is still in its infancy. The term “macro-prudential” has seen almost inflationary use[51] and while the theoretical foundations have been laid down, the precise set of tools and the know-how how such tools and analysis interact with monetary policy is still being developed.

The report on the ESRB is focused therefore more on the mission and organization of the ESRB.

The ESRB Regulation stresses the preventive role of the ESRB in that it should ‘contribute to the prevention of systemic risks’ and ‘avoid periods of widespread financial distress’. In addition, the ESRB should ‘identify and prioritise systemic risks’.

It is difficult to assess the ESRB's performance as a forward-looking macro-prudential authority given its only recent inception.

Similar as with the ESAs, it is recognized that the ESRB is a key component of the ESFS, but stakeholders identified areas for improvement.

These areas for improvement mainly relate to organisational identity, internal governance and the available tools (i.e. warnings and recommendations).

Stakeholders have for instance called for:

- Increased transparency to enact the “act or explain” mechanism
- Better interaction with other European bodies
- Better framing of ESRB intervention in the field of legislation so that ESRB views do not come at a very late stage of the legislative process
- Enhancement of external communications
- Improvement of exchange of data between ESRB and ESAs
- Expand “tool box” to more “soft powers” in addition to the existing very “formal recommendations” that are cumbersome, often come late or, in one case, after the problem had already been addressed

3) Banking Union and SSM challenges

As regards the Banking Union, of which the above-mentioned institutions are just one element, there is a more sceptical outlook.

This starts with the practical observation that there will necessarily and correctly be a division of labour between national supervisory authorities and central SSM staff at the ECB; this raises practical questions of organisation and decision making, in particular. At the bottom of the system will be the various national supervisors each

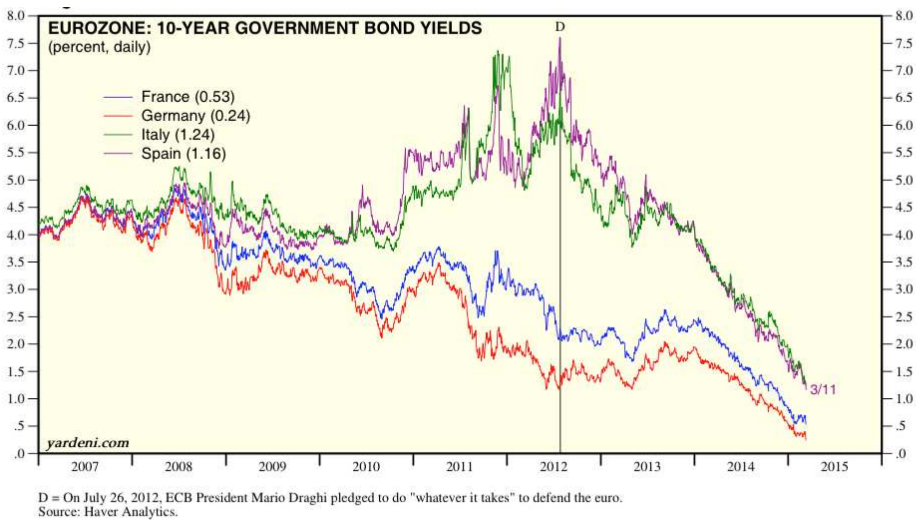
[51] Clement (2010).

feeding up dozens if not hundreds of issues and matters for decision and action, with this volume surging in times of stress.[52] The ECB also had to recruit between 800 and 1000 new staff for this task, and will now keep on renting its former building to house its supervisory staff, while the core of the ECB moved to a new building in Frankfurt late last year, formally inaugurated just recently, on 18 March.

As the report on the ESFS pointed out, “the establishment of a Banking Union, and notably of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) as its key components, will impact the functioning of the ESFS, but does not call into question its existence and necessity. To the contrary, the ESAs will continue to be responsible for the establishment of common regulatory and supervisory standards and practices and the consistent application of EU measures across the Single Market. An assessment of the interactions between the ESFS and the Banking Union would be premature at this stage but will be closely monitored in the future.”

A researcher of a large commercial bank in the Eurozone pointed out, in my view correctly, that supervision, resolution and rulebook are strictly interconnected. Supervision without a single rule book would leave supervision fragmented and competition distorted and would incentivise member states to game the rules. Supervision without joint resolution would not break the vicious circle – and neither would resolution without burden- sharing.[53] Finally, joint resolution without joint supervision would create moral hazard.[54]

On the other hand, the decisive move to have created a better integrated financial supervisory architecture in Europe may have contributed to the renewed trust by markets in the Eurozone, as evidenced by bond yields (see graphic below).[55]



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52 Elderfield (2013).

53 See Goodheart/Schoenmaker (2006).

54 DB Research, “EU Banking Union: right idea, poorly executed”, EU Monitor, 4.9.2003,

55 Yardeni Research, Country briefing Eurozone, 12.3.2015; www.yardeni.com

IV. CONLUSIONS

The European experience shows that creating a common financial market and financial space is a lengthy, perhaps never ending process.

This is even more the case where countries with different organizational and cultural traditions yet a common currency are required to cooperate, as at least the systemically important financial institutions have long ceased to operate merely on a national level. This has required the creation of structures that are also transnational and that go beyond a mere information exchange.

The European experience can nevertheless be of use to the Caribbean. Having merely a set of MoU and entirely independent national supervisory authorities clearly did not work in the European context.

For the Caribbean, in the absence of a common currency and centralized monetary and supervisory institutions, it is my personal view that in the short to medium term strong cooperative arrangements, paired with possible adaptions in governance[56] and accountability arrangements would seem preferable over creating a new centralized joint authority

Strong cooperative arrangements could contribute to creating comparable and thus more easily compatible sets of rules, for instance as regards organizational structure of relevant institutions, as well as the tools for analysis and intervention. In other words having the same or largely similar organizational and regulatory arrangements in each country, but adopted individually, might be easier to arrive at than creating a joint body that issues rules that then become binding or need to be adopted in the region's countries.

And as banking federations are actively supporting the Banking Union concept in Europe and actively participate in the various consultative processes[57], the Caribbean Association of Banks might also be asked to provide active input to a regional risk assessment and management framework.

It might also be useful to study the experience of other regions besides the EU that have tried to establish institutional frameworks for financial sector supervision or at least enhance the effectiveness of cross-border supervision.[58]

In any event, if a joint assessment and management of risks in the Caribbean is envisioned, it would seem important to think hard of the organizational structure of

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[56] See for instance, Caruana (2014).

[57] http://www.ebf-fbe.eu/ebf-tag/supervision-stability-and-structure/

[58] See section on "supervisory coordination" in CGFS (2014).

As an example for the SADC region, see "Cross-border banking supervision in the SADC region", ACM Insight, Vol 4, issue2, 2013, http://www.opml.co.uk/sites/default/files/ACM_INSIGHT__Volume_4_Issue_2_2013.pdf. On proposals for Asia (including the never realised "Asian financial stability dialogue"): Kawai/Morgan (2014). For the West African Monetary Union: "Comité de stabilité financière" under the auspices of the BCEAO, http://www.bceao.int/Le-Comite-de-Stabilite-Financiere.html.

any cooperative framework, the decision making processes, governance, accountability and transparency and, last but not least, funding.

The process is more complex than one might think and does not guarantee success.

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