

The Limitations of Regulating Macro-Prudential Supervision in Europe

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Introduction

The *De Larosière Report* included an important conclusion regarding the lack of a sufficiently developed macro-prudential supervisory framework in Europe. The High Level Group noted:

"The present EU supervisory arrangements place too much emphasis on the supervision of individual firms, and too little on the macro-prudential side. The fact that this failing is duplicated elsewhere in the world makes it a greater, not a lesser, issue. The Group believes that to be effective macro-prudential supervision must encompass all sectors of finance and not be confined to banks, as well as the wider macro-economic context. This oversight also should take account of global issues. Macro-prudential supervision requires, in addition to the judgements made by individual Member States, a judgement to be taken at EU level. The Group believes that this requires that an Institution at EU level be entrusted with this task. It recommends that the ECB/ESCB be explicitly and formally charged with this responsibility in the European Union."¹

The European Commission immediately responded to this recommendation by proposing in May 2009 that, in parallel with the other measures to be taken at a European level, an institutional framework should be established to enable better co-ordination of macro-prudential supervision in Europe.² This macro-prudential supervision model is to be created pursuant to a Regulation establishing a new European Systemic Risk Board (ESRB) which will:

"[M]onitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole."³

The role of the ESRB will be to provide an early warning of system-wide risks that may build up in the financial sector with the aim of avoiding fundamental weaknesses of the system that have become apparent during the financial crisis in the wake of the collapse of Lehman Bros in the fall of 2008. The various collapses of significant financial institutions highlighted the fact that many models for supervision of the financial sector focused too heavily on micro-prudential regulation and therefore on individual institutions, rather than balancing that with supervision of interconnected, complex, sector and cross-sectoral systemic risks.⁴

In this article, the author comments on the legislative proposals that have been developed in Europe since the publication of the European outline for the ESRB in May 2009 and the status of these proposals. Furthermore, he shall use a recent study of the Committee on the Global Financial System of the Bank of International Settlements (BIS) as a framework to further assess the hypothesis of this article. This hypothesis being that, notwithstanding the creation of a complex institutional framework for macro-prudential supervision in Europe, the successful operation of this new supervisory instrument will from the outset be hampered by the lack of a common definition of what constitutes macro-prudential supervision and the lack of consensus as to the objectives of policy makers.

The European institutional framework

The May 2009 Communication from the Commission has been followed up by the publication of a Proposal for a Regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board dated September 23, 2009 (ESRB Regulation).⁵ On the basis of art.95 EC,⁶ the ESRB shall be established as a, "body without legal personality". The ESRB shall therefore be an ad hoc committee that derives its authority from the ESRB Regulation. The establishment of the ESRB will furthermore be supported by a decision of the European Council that will mandate that the European Central Bank (ECB) establish the secretariat of the ESRB. The ECB will provide for, "administrative, logistical, statistical and analytical support to the ESRB".⁷ The relevant tasks entrusted to the ECB will be the first application of art.105 para.6 EC;

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¹ High Level Group on Financial Supervision, chaired by Jacques De Larosière, *Report of February 25, 2009*, pp.39–40, available at http://ec.europa.eu/internal_market/finances [Accessed July 27, 2010].

² For a detailed discussion of the proposals in the May 2009 Communication from the European Commission see: Marco Lamandi, "When more is needed: The European Financial Supervisory Reform and Its Legal Basis" 6(5) *European Company Law* 197; Donato Masciandaro, "Regulating the Regulators: The Changing Face of Financial Supervision Architectures before and after the Crisis" (2009) 6(5) *European Company Law* 187; and Tony Ciro and Michael Longo, "The Global Financial Crisis: Causes and Implications for Future Regulation: Part I" (2009) 12 *J.I.B.L.R.* 599 and "Part II" (2010) 1 *J.I.B.L.R.* 9.

³ *Communication on European financial supervision COM(2009) 252 final*, p.3.

⁴ *Communication on European financial supervision COM(2009) 252 final*, p.3.

⁵ *Proposal for a Regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board COM(2009) 499 final*.

⁶ Treaty on the Functioning of the European Union in its consolidated text has renumbered this provision to art.114, see: [2010] OJ C83.

⁷ *Proposal for ESRB Regulation COM(2009) 499 final*, p.4.

upon adoption of a unanimous decision of the European Council, certain prudential supervision tasks may be delegated to the ECB.⁸ The ECB will bear the budgetary consequences of establishment of the ESRB.

The ESRB will have a General Board consisting of the governors of all the national central banks of the Member States of the European Union. As the establishment of the ESRB is based on art.95 EC, the adoption of the ESRB Regulation will have relevancy for the European Free Trade Association Member States participating in the European Economic Area (EEA). Therefore it is expected that the governors of the national central banks of Iceland, Norway and Liechtenstein will also form part of the General Board of the ESRB. The President and Vice-President of the ECB will also be members of the General Board as will a member of the European Commission. In order to align the objectives of the ESRB and those of the three European supervisory authorities (being the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)), the chairpersons of the three European supervisory authorities will also become voting members of the General Board of the ESRB. One senior representative of each national supervisory authority of each EU Member State as well the President of the Economic and Financial Committee⁹ shall have a non-voting membership position on the General Board. The representatives of the national supervisory authorities may rotate as often as required in view of the topics to be discussed in the General Board. This rotation enables Member States to send representatives of the different supervisory authorities for the different financial sectors to meetings of the General Board. For instance, Member States may send members of the supervisory authority for the insurance sector to meetings if relevant topics for the insurance industry are scheduled for discussion rather than topics for the banking industry.

The chairperson of the General Board shall be appointed for five years from among the voting members of the General Board that are also part of the member of the General Council of the ECB. In practice this means that the General Board shall always be chaired by one of the governors of a national central bank of one of the Member States of the European Union/EEA. This element of the ESRB Regulation differs from the initial proposals set forth in the *De Larosière Report* and the Communication from the European Commission of May 2009 where it was proposed that the chairperson of the ESRB was to be the President of the ECB. This change occurred after deliberations in the Economic and Financial Affairs Council (ECOFIN) meeting held in June 2009. Due to the large number of participating members in the

General Board, its work will be supported by a smaller Steering Committee. The membership of the Steering Committee will be made of the chairperson and the vice-chairperson of the General Board, the chairpersons of the European supervisory authorities and five members of the General Board that are also members of the General Council of the ECB.

The General Board and its Steering Committee will be supported by the ECB Secretariat. The Secretariat will be primarily responsible for the organisation of meetings and the collection of all quantitative and qualitative information stemming from the work that is conducted by the ECB, the European System of Central Banks and the European supervisory authorities. The Secretariat will also support the work of the Advisory Technical Committee (ATC). The ATC is to provide technical advice and assistance to the General Board at the request of the board. The ATC will be composed of one representative of each of the: (i) national banks of EU Member States; (ii) the ECB; (iii) a supervisory authority of each Member State; (iv) of each European supervisory authority; (v) the Economic and Financial Committee and two representatives of the European Commission.

Neither the ESRB and nor any of its constituent bodies will have any binding powers to impose measures on Member States or national authorities. Its role will predominantly be to deliver opinions that will, in view of the "reputational" impact of such opinions influence the course of affairs within one or more Member States to which such opinion is addressed. The ESRB will have an impact because of its moral authority. To that end, the ESRB may:

"[N]ot only provide high quality assessment of the macro-prudential situation but it may also issue risk warnings and recommendations which identify the potential unbalances in the financial system which are likely to increase systemic risks and the appropriate remedial actions."¹⁰

At the ECOFIN meeting of October 20, 2009, the proposal for the ESRB Regulation was approved.¹¹ ECOFIN provided broad support to the Proposal for the ESRB Regulation and requested the Commission start negotiations for the adoption by the European Parliament of the ESRB Regulation in 2010 with the aim to establish the ESRB effective January 1, 2011. The Committee on Legal Affairs of the European Parliament recommends adoption of the ESRB Regulation in its advice of April 30, 2010 with minimal amendments to the original proposal of the European Commission in line with the

⁸ Article 105 is in the consolidated text of the Treaty on the Functioning of the European Union [2010] OJ C83; art.127 and para.6 of this provision determines: "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."

⁹ This is a committee established pursuant to art.114 EC and entrusted with an advisory role to the European Commission and the European Council. It is composed of (high level) civil servants (from the ministries of finance) appointed by the Member States of the EU/EEA and two representatives appointed by the European Commission.

¹⁰ *Proposal for ESRB Regulation COM(2009) 499 final*, p.5.

¹¹ Press release, 2967th Council meeting Economic and Financial Affairs, Luxembourg, October 20, 2009, 14601/09 (Presse 294).

recommendations of the other committees of the European Parliament.¹² It is therefore expected that the ESRB Regulation will be submitted for voting in European Parliament without further material revisions to the final text.

The definition of macro-prudential supervision in the ESRB Regulation

The ESRB Regulation does not contain a definition of what constitutes macro-prudential supervision. The ESRB Regulation does, however, define two concepts that are relevant for the interpretation of the roles of the ESRB in connection with macro-prudential supervision. First, the ESRB Regulation contains a definition of "financial institution" that, rather unhelpfully, deviates from existing definitions in other European laws of this concept. A "financial institution" is pursuant to art.2 of the ESRB Regulation:

"[A]ny undertaking whose main business is to take deposits, grant credits, provide insurance services or other financial services to its clients or members or engage in financial investment or trading activities on its own account."¹³

The second, significant, definition is given in art.2 of the ESRB Regulation of "financial system", which states, "all financial institutions, markets and market infrastructures".

In art.3 para.1 of the ESRB Regulation, the mission, objective and tasks of the ESRB are set out. This provision of the regulation determines that:

"The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Community¹⁴ in order to prevent or mitigate systemic risks within the financial system, so as to avoid episodes of widespread financial distress, contribute to a smooth functioning of the Internal Market and ensure a sustainable contribution of the financial sector to economic growth."

It must be emphasised that the ESRB's role will not be restricted to the banking sector only. Without this being spelled out in the various policy documents of the European institutions, restricting macro-prudential supervision to the regulated banking sector only, would have missed the wider goal of creating a comprehensive authority for the ESRB capable of addressing risks to the financial markets by participants that are not subject to banking supervision.

With the broad definitions of "financial institutions" and "financial system" and the broad objectives as defined in art.3(1) of the ESRB Regulation, the ESRB will in any

event be authorised to take a broad view on developments in the financial markets. The definitions and objectives of the ESRB Regulation capture both regulated and unregulated entities and banks or other financial institutions, such as insurance companies, investment firms or entities involved in the clearing and settlement of securities or payments transactions.

In order to meet the objective of art.3(1) of the ESRB Regulation, the ESRB shall carry out the tasks as defined in para.2 of that article. The most important elements of the list of tasks are to be found in ss.(a) up to and including (e) as follows:

- "(a) Determine and/or collect, as appropriate, and analyse all the information relevant for the mission described in paragraph 1;
- (b) identify and prioritise such risks;
- (c) issue warnings where risks are deemed to be significant;
- (d) issue recommendations for remedial action where appropriate;
- (e) monitor the follow-up to warnings and recommendations."

In Ch.III of the ESRB Regulation each of these tasks is described in more detail, defining the exact roles of the ESRB and the manner in which the tasks are to be carried out in conjunction with the various relevant European and other international organisations. A core provision of this Ch.III is laid out in art.17 of the ESRB Regulation, which establishes the "comply or explain" principle. This principle determines that addressees of recommendations of the ESRB, whether this be one or more Member States of the European Union/EEA, one or more of the European supervisory authorities or one or more national supervisory authorities, must explain to the ESRB if its recommendations have not been followed up in the manner suggested by the ESRB. A soft sanction instrument supportive to this system of recommendations, is the ability of the ESRB, pursuant to art.18 of the ESRB Regulation, to make a warning or recommendation public, be it that this authority may only be exercised subject to qualified majority decisions within the General Board of the ESRB.

Systemic risk as core objective for preventive measures in the ESRB Regulation

A common view expressed in literature and in statements of regulators and politicians is that macro-prudential supervision is in its early stages of development. What constitutes macro-prudential supervision and where the emphasis of this new area of supervision should be laid

¹² Opinion of the Committee on Legal Affairs for the Committee on Economic and Monetary Affairs on the proposal for a regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board COM(2009)0499 (C7-0166/2009—2009/0140(COD)).

¹³ The careful reader will notice that this concept deviates substantially from the definition of "financial institution" in Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177/1 ("the Capital Requirements Directive ("CRD")") which is, in broad terms, defined as a subsidiary of a bank carrying out one or more of the activities listed in Annex I of the CRD Directive that is not permitted to raise deposits from the public.

¹⁴ Amendment no.1 of the Committee on Legal Affairs of the European Parliament proposes to amend this to "Union".

is still a matter of discussion. Notwithstanding the commitment of policy makers to further develop a more concrete direction in this area of supervision of the financial markets, macro-prudential supervision is often associated with the avoidance of systemic risk. Systemic risk is also the central focus point that has been the basis of the establishment of the core objectives of the ESRB in art.3(1) of the ESRB Regulation. What constitutes "systemic risk" is, however, in its turn not precisely defined in the ESRB Regulation.

Substantial research on the nature of systemic risk was undertaken long before the recent financial crisis occurred.¹⁵ Both in official policy statements and academic literature, many definitions of what constitutes "systemic risk" have been developed. Moreover, many studies have been conducted to attempt to define how systemic risk may be attributed to individual institutions, the so-called "too big to fail" or "too interconnected to fail" issue.¹⁶

One of the earlier official policy definitions of "systemic risk" can be found in the G10 report on *Consolidation in the financial sector* of January 2001:

"Systemic financial risk is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy."¹⁷

As may be appreciated, this definition lacks precision and it is therefore worthwhile seeing whether other definitions are more exact. In an overview article commenting on all definitions of "systemic risk" as developed in academic literature before 2003, Kaufman and Scott define this concept as follows:

"Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co movements (correlation) among most or all the parts."¹⁸

Departing from this generic definition, they went on to develop three concepts of "systemic risk" as commonly described in policy statements of regulators and in literature:

- (a) The *first concept* defines "systemic risk" as a "'big shock' or macro shock that produces nearly simultaneous, large, adverse effects on most or all of the domestic economy or system". In this concept the transmission of effects from such a macro shock to individual institutions in the financial markets is not precisely defined.
- (b) The *second concept* defines "systemic risk" from the perspective of, "transmission of the shock to individual institutions and a potential spill over from one unit to others".¹⁹
- (c) The *third concept* defines "systemic risk" also as a spill over from, "an initial exogenous external shock, but it does not involve direct causation and depends on weaker and more indirect connections". In this concept the systemic risk is more related to a reassessment by participants in the financial markets on the risks taken in respect of positions in individual firms and the consequential actions stemming from such reassessment. It is a concept of "indirect causation".²⁰

In legal terms the difference between concepts (b) and (c) could be described as automatic trigger events and events in which a trigger does not per se result into a follow-up action but may result in such follow-up reaction.

In 2008 Schwarcz developed a detailed overview of the various elements of the definition of systemic risk that he had found in literature and concluded that the following common elements could be noted:

"A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences sometimes referred to as the domino effect. These consequences could include (a chain of) financial institution and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial

¹⁵ For an overview of studies organised on this subject matter, see: George G. Kaufman and Kenneth E. Scott, "What is systemic risk, and do bank regulators retard or contribute to it?" (2003) VII(3) *The Independent Review* 371; Proceedings of the Third Joint Central Bank Research Conference of the Committee on the Global Financial System, *Risk measurement and systemic risk* (October 2002), available at <http://www.bis.org> [Accessed July 27, 2010]; Donato Masciandaro, "Reforms of Financial Supervision regimes and Central Banks, Exploring The Nexus", paper presented at the Conference on Macro Prudential Supervision: Challenges for Financial Supervisors, organised by the International Monetary Fund and the Korean Supervisory Authority, Seoul, November 7-8, 2006 and "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations", Background Paper of the Financial Stability Board, International Monetary Fund and BIS, report to the G-20 Finance Ministers and Central Bank Governors, October 2009, to be consulted at <http://www.financialstabilityboard.org> [Accessed July 27, 2010].

¹⁶ See for a recent study on these topics: Nikola Tarashev, Claudio Borio and Kostas Tsatsaronis, *Attributing systemic risk to individual institutions*, BIS Working Papers no.8 (Monetary and Economic Department of the BIS, May 2010), available at <http://www.bis.org> [Accessed July 27, 2010].

¹⁷ See <http://www.oecd.org/document/60> [Accessed July 27, 2010].

¹⁸ Kaufman and Scott, "What is systemic risk, and do bank regulators retard or contribute to it?" (2003) VII(3) *The Independent Review* 371.

¹⁹ Noteworthy is the definition of the BIS that is cited in the article of Kaufman and Scott where it defined systemic risk in 1994 as, "the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default with a chain reaction leading to broader financial difficulties". In this definition, "systemic risk" is rather focusing on market infrastructure and interconnected contractual obligations. This interconnected pattern may be found for instance in the derivatives markets, where a default of an end user in a derivatives transaction, may accumulate in a series of defaults or cross defaults between the same party with a potential spill over to other parties too.

²⁰ Kaufman and Scott, "What is systemic risk, and do bank regulators retard or contribute to it?" (2003) VII(3) *The Independent Review* 371, 371-373.

financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both.”²¹

Finally, the most endorsed definition of “systemic risk” at present was developed by the joint efforts of the IMF, Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB) in the October 2009 report, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*²² where the concept was defined as:

“It is the disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.”

Taking all the definitions of systemic risk as a starting point, it is important to link these definitions to the manner in which policy makers and regulators are capable of responding to such risks. It is the core objective set forth in art.3(1) of the ESRB Regulation whereby the ESRB is supposed to “prevent or mitigate” systemic risks. To that end the ESRB shall perform the tasks as set forth in para.2 of art.3(1) of the ESRB Regulation and further emphasised in Ch.III of the ESRB Regulation. These elements of the ESRB Regulation are discussed in para.3. The ESRB is within this legal framework authorised to cast early warnings on (systemic) risks that it considers to be significant. Such warnings may be accompanied with recommendations on “remedial actions” to be taken either by Member States of the European Union/EEA, the European supervisory authorities or the national supervisory authorities of the Member States. This legal framework lacks, however, precision as regards the concrete measures and the concrete topics that may form part of the “warnings and recommendations” of the ESRB and the exact materiality of what would constitute recommended “remedial actions”.

The report of the Committee on the Global Financial System

In May 2010 the Co-ordinating Group of the Committee on the Global Financial System of the BIS (CGFS) published its report, *Macro-prudential instruments and frameworks: a stock taking of issues and experiences*.²³ This survey presents a preliminary study on empirical evidence of macro-prudential measures established in a number of regions in the world. It aims at contributing concrete recommendations to policy makers working towards the establishment of a system of macro-prudential supervision. The CGFS presents the outcome of studies carried out by the Co-ordinating Group and workshops held with a large number of representatives from

European, Asian and American policy makers and regulators in order to prepare for the further studies to be developed by the FSB, BCBS and the G-20 due to be finalised mid-2010.

The CGFS has worked with the commonly developed definition of “systemic risk” as established by the joint initiative of the IMF, BCBS and FSB in October 2009, but reiterates that the definition is still being reviewed in the international fora. In order to define the context in which the prevention of systemic risk serves as one of the core objectives of macro-prudential supervision, the Committee furthermore considers:

“Policymakers broadly agree that the purpose of macroprudential policy is to reduce systemic risk, strengthening the financial system against shocks and helping it to continue functioning stably without emergency support on the scale that was extended in the crisis. Preventative in its orientation, macroprudential policy is distinct from financial crisis management policy. Views vary on how macroprudential policy should be defined and implemented. Questions also surround the choice of available instruments and the ways in which they might operate. Central banks have a stake in macroprudential policy. First, they are seen as bearing important responsibilities for financial stability, if sometimes only implicitly so. Second, the objectives, instruments and conduct of macroprudential policy are part of an overall economic and financial stabilisation function that includes monetary policy. Successful macroprudential policy and monetary policy can reinforce each other to stabilise the economy.”²⁴

The difficulties in defining the exact scope of macro-prudential supervision are demonstrated by these considerations, where measures to address macro-prudential objectives need to be closely aligned with monetary instruments available to central banks and monetary authorities. Furthermore, macro-prudential supervision instruments should be placed in the context of prevention and are not to be associated with ex post crisis management measures as applied in the recent past to address the serious disruptions of the financial markets. In a further attempt to address the relative position of macro-prudential measures in the whole context of financial supervision, the CGFS notes the following:

“Macroprudential policy focuses on the interactions between financial institutions, markets, infrastructure and the wider economy. It complements the microprudential focus on the risk position of individual institutions, which largely takes the rest of the financial system and the economy as given. Clearly, neither type of policy is a substitute for

²¹ Steven L. Schwarcz, “Systemic Risk” (2008) 97 *The Georgetown Law Journal* 193.

²² *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, pp.5–6.

²³ Co-ordinating Group of the Committee on the Global Financial System of the BIS (CGFS), *Macro-prudential instruments and frameworks: a stock taking of issues and experiences*, CGFS papers no.38 (May 2010), available at <http://www.bis.org> [Accessed July 27, 2010].

²⁴ CGFS, *Macro-prudential instruments and frameworks: a stock taking of issues and experiences*, 2010, p.2.

sound risk management in the private sector, which should as far as possible internalise the risk of potential losses.

The vagueness of the definition of systemic risk reflects its dependence on time- and economy-specific circumstances, as well as the current lack of knowledge about the behaviour of the financial system, its interactions with the economy, and their sensitivity to policy interventions.

In articulating the practical objectives of macroprudential policy, two aims might be distinguished. The first is to *strengthen the financial system's resilience to economic downturns and other adverse aggregate shocks*. The second is to *actively limit the build-up of financial risks*. Such leaning against the financial cycle seeks to reduce the probability or magnitude of a financial bust.²⁵

What must be noted, is the difference between the objectives as set forth in the ESRB Regulation and the comments of the CGFS, particularly as concerns the "leaning against the financial cycle" measures that are more concrete than the objectives as formulated by the European legislator. Displaying a number of concrete policy measures that fit into this objective, the CGFS describes the practices developed in a number of regions and the (relative) success such measures have potentially had. The following examples of macro-prudential measures are given:

- "(i) instruments that limit leverage in particular types of lending contracts, for instance by applying a fixed loan-to-value ratio to the financing of immovable properties ('Limits calibrated to borrower risk characteristics');
- (ii) aggregate or sectoral credit growth limits, such as restrictions on credit card lending ('Absolute limits');
- (iii) Size-dependent leverage limits or asset risk weights, capital surcharges for systemically important institutions ('Limits on leverage');
- (iv) Limits on interbank exposures ('Financial system concentration limits');
- (v) Time-varying capital requirements, restrictions on profit distribution ('Capital');
- (vi) Countercyclical/dynamic provisioning ('Provisioning')²⁶;
- (vii) Loan-to-deposit limits, core funding ratios, reserve requirements ('Liquidity risk');
- (viii) Limits on open currency positions, on derivatives transactions ('Currency risk')."²⁷

The CGFS notes that when defining what constitutes measures of effective macro-prudential supervision, one of the concerns that may arise when addressing policies that are directed to regulated financial institutions, is that such measures do not necessarily capture businesses that are capable of avoiding being regulated and providing for an alternative product offering in case regulated institutions are restricted to offering financial products or services to their customers in view of macro- or micro-prudential regulations. This is also addressed as the issue of regulatory arbitrage. Furthermore, the CGFS notes that one of the complexities of developing effective macro-prudential measures relates to the ability to develop effective supervision policies and practices for institutions operating cross border.

The report also demonstrates that it is not easy to define what constitutes an effective macro-prudential measure that addresses systemic risks in all relevant financial markets. It is with a view to this complexity, that we note that on the one hand it is understandable that the compromises set forth in the ESRB Regulation do not contain a precise definition of macro-prudential supervision, but on the other hand it may be questioned whether this lack of definition will ultimately not result in an ESRB being unable to implement robust policies and directions to meet the objectives of macro-prudential supervision as contemplated by the ESRB Regulation.

The relation with micro-prudential supervision

One of the most significant challenges in defining what constitutes a proper framework for macro-prudential supervision in Europe is to align the authorities of the ESRB with those of the various authorities involved in micro-prudential supervision. As has been noted by the CGFS, the definition of what constitutes macro-prudential supervision and measures stemming from this area is often closely related to micro-prudential measures:

"In most economies, macroprudential policy frameworks are at an early stage of development. They have been implemented using existing microprudential monetary policy and liquidity management mandates and institutions. And, macroprudential interventions have taken the form of adjustments or add-ons to instruments already used for microprudential or liquidity management purposes."²⁸

As may be noted from the list of examples of macro-prudential measures from the May 2010 report of the CGFS, many of those instruments are closely related to or originate from micro-prudential rules that generally apply to certain financial institutions. It would be wrong to define such measures as being macro-prudential

²⁵ CGFS, *Macro-prudential instruments and frameworks: a stock taking of issues and experiences*, 2010, p.3.

²⁶ Where the Spanish instrument adopted mid-2000 has been given as an important example. See Jesús Saurina, *Loan Loss Provisions in Spain. A working Macroprudential Tool* (Banco de España, Estabilidad Financiera, no.17), pp.11–26.

²⁷ See CGFS papers no.38, May 2010, p.12.

²⁸ CGFS papers no.38, May 2010, p.8.

measures because they differ from micro-prudential measures as regards their scope of application to a whole sector or to financial institutions of a certain type. Micro-prudential rules and standards often apply generally to certain sectors in the financial industry or to certain types of financial institutions.

A clear example of a micro-prudential rule that also appears on the CGFS list of macro-prudential measures, is the category of measures that the CGFS classified under, "Limits calibrated to borrower risk characteristics". Loan-to-value (LTV) limitations are, according to the CGFS, an important example of this category of macro-prudential measures. But rules on the maximum LTV in applying underwriting standards in the loan businesses of banks are not new for the banking industry. Clearly, such rules are a distinguishing element of the capital adequacy framework for the credit risk assumed by banks. The relevant rules are for instance further defined as a principle in the rules for the risk weighting of claims secured by residential property in the Basel II Accord.²⁹ In Europe the relevant principles of the Basel II Accord are detailed in the rules set forth in para.9.1 of Annex VI of Directive 2006/48. In many European jurisdictions the relevant LTV values established to address the permissible risk weighting of exposures in the banking book related to loans secured by residential properties are close to the percentages for a maximum LTV ratio as has been suggested by the CGFS as being a reasonable maximum LTV ratio to be applied as a macro-prudential measure. Rules on maximum LTV ratios are therefore not new for Europe and indeed stem from the initial rules of the Basel I Capital Accord rules with the adoption of a risk weighting of 50 per cent for loans secured by residential properties as set forth in Directive 89/647 on a solvency ratio for credit institutions.³⁰ So what is now presented as an adequate measure of macro-prudential supervision in the May 2010 report of the CGFS, has already been a rule of law for decades in the banking industry.

Another example is the category, "Financial system concentration limits", where the macro-prudential measure should restrict banks from taking too large exposures on other financial institutions. With the adoption of the revised framework for "large exposures" in the CRD II Directive³¹ resulting in significant amendments to the provisions of arts 106 et seq. of Directive 2006/48 (CRD), the rules on the lending limits for banks have been expanded to include rules on maximum exposures on credit institutions and investment firms. The adoption of this new framework in 2009 was motivated by the fact, that the European legislator concerned large exposures in the interbank environment

were resulting in vulnerabilities equally severe as any other large exposures to clients or a group of connected clients.

Many other examples may be given in which measures that have been presented as typical macro-prudential instruments, are already regulated in the existing micro-prudential legal framework. Furthermore, many of the macro-prudential measures as contemplated by the CGFS are already being or to be regulated in the revised rules for capital adequacy of banks in the micro-prudential framework. This is particularly the case for the measures concerning the improvement of the capital base of banks, countercyclical provisioning, improved liquidity management and limits on leverage. It is particularly these areas that are currently forming part of the substantial revisions to the Basel II Accord and the European CRD Directive being proposed in the recent work of the BCBS and the European Commission.³²

In conclusion, it must be noted that what constitutes a properly defined framework for macro-prudential supervision and prevention of systemic risk, is not necessarily new in the supervision of financial institutions and is at risk of resulting into overlap with the supervision domain of micro-prudential authorities.

Closing remarks

The fuzziness of the definition of macro-prudential supervision and the measures that macro-prudential supervisory authorities could take in order to address systemic risk will in my view be an important obstacle for the effective realisation of the objectives as currently comprised in the European framework for the ESRB. The institutional framework for the creation of the ESRB as set forth in the ESRB Regulation does not deal with the potentially duplicative efforts to be undertaken on the one hand by the European supervisory authorities when establishing best practices and good governance in the domain of cross border European micro-prudential supervision and on the other hand the role that the ESRB will have to play in establishing the macro-prudential side of supervision of the financial sector.

What is often presented in the first studies on the effectiveness of macro-prudential measures as typical for this part of the supervision of the financial markets and its participants, may very well end up becoming the primary domain of the micro-prudential supervisory authorities after the adoption of the revised rules on enhancement of capital and liquidity supervision. The constraints in defining a proper distinction may be found in the area of countercyclical capital charges. The Spanish system of dynamic provisioning is the clearest example

²⁹ In the standardised approach these rules can, for instance, be found in paras 72 and 73 of the Basel II Accord, *International Convergence of Capital Measurement and Capital Standards* (a revised framework, Comprehensive Version, June 2006), p.24.

³⁰ Directive 89/647 on a solvency ratio for credit institutions [1989] OJ L386/14

³¹ Directive 2009/111 amending Directives 2006/48, 2006/49 and 2007/64 as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management [2009] OJ L302/97.

³² See BCBS, *Strengthening the resilience of the banking sector*, (December 2009); BCBS, *International framework for liquidity risk measurement, standards and monitoring* (December 2009), both consultative papers to be consulted at <http://www.bis.org> [Accessed July 27, 2010] and as regards the European mirroring proposals: Commission Services Staff Working Document, *Possible Further Changes to the Capital Requirements Directive* (February 2010).

of a measure presented as a macro-prudential tool.³³ The question arises whether the effects of a generally applicable rule for the banking sector where banks may either rely on internal modelling of the relevant credit risks resulting from the loan portfolio or, absent availability of such an internal model, should use the models developed by the banking regulator using general market statistical data is really distinct from what is currently being contemplated in the revision of capital requirements in the micro-prudential framework. The BCBS notes in the recent consultative paper, *Strengthening the resilience of the banking sector*:

"One of the most destabilising elements of the crisis has been the procyclical amplification of financial shocks throughout the banking system, financial markets and the broader economy. The tendency of market participants to behave in a procyclical manner has been amplified through a variety of channels, including through accounting standards for both mark-to-market assets and held-to-maturity loans, margining practices, and through the build up and release of leverage among financial institutions, firms, and consumers. The Basel Committee is introducing a number of measures to make banks more resilient to such procyclical dynamics. These measures will help ensure that the banking sector serves as a shock absorber, instead of a transmitter of risk to the financial system and broader economy."³⁴

All of the measures proposed by the BSCB will impact the current rules applicable in the micro-prudential framework. They may result in new parameters for the calculation of risk weights attached to exposures of banks in their banking books and trading portfolios. They most probably will also result in new definitions of the capital of banks that should be maintained to absorb losses. They will in all likelihood also address the subject matter of regulating systemically important banks. All of these measures are ultimately directed to make individual banks more resilient against economic downturns. The measures will, naturally, impact individual institutions as a result of the application of the micro-prudential rules applicable to these institutions. The open question is how these measures should be placed in the context of macro-prudential supervision.

This brings us back to the ambitions of the European legislator when introducing the institutional framework for macro-prudential supervision through the establishment of the ESRB. In defining the objectives of the ESRB, the European legislator has provided for a broad concept and broad objectives to be achieved with the establishment of a European system for

macro-prudential supervision. Absent clear definitions of what constitutes macro-prudential supervision and even what constitutes "systemic risk" as one of the core focus points of the system of early warnings and preventive measures, it appears that the ESRB once established and operating will have to work in an environment with many open ends and with great uncertainties as to what exactly should be its role. In contrast to the substantial work that is currently being undertaken by policy makers and regulators to address the ambitious agenda for the reform of the micro-prudential regulatory framework, there is at present only a very first beginning of a proper definition of what constitutes macro-prudential supervision.

With the exception of the forthcoming regulations on alternative investment funds³⁵ and the work underway to regulate the European markets for derivatives,³⁶ little attention has been given thus far to a number of other topics that are relevant for the proper establishment of a comprehensive definition of macro-prudential supervision. These topics include the subject matter of addressing macro-prudential measures to institutions or undertakings that are capable of rendering financial services without being regulated from the perspective of prudential supervision in a way similar to the standards applied to banks. Examples of such institutions may be found in the area of institutions involved in the origination of significant lending portfolios without being regulated as a bank. One could think of life-insurance companies that build up mortgage-backed loan portfolios. Another example may be found in the area of consumer lending, where in many jurisdictions in Europe offerors of consumer lending products, such as credit-card facilities or car loans, are regulated from the perspective of consumer protection, but not necessarily from the perspective of prudential supervision. The definition of "financial institution" as included in art.2 of the ESRB Regulation suggests that the ESRB will also have the task to monitor these parts of the financial markets and provide for early warnings and recommendations for remedial actions. But what is unclear is how the ESRB will be able to effectively address these measures, if the relevant individual entities or unregulated sectors may not be disciplined because they are not regulated entities or a regulated sector or where the regulation of these entities does not include a framework for prudential supervision that focuses on the relevant part of the business where the "systemic risk" may build up.

The ESRB Regulation has been the first major legislative proposal for the reform of financial supervision that has been accepted by the European Council and that is likely to be adopted shortly by the European Parliament as formal legislation of the European Union. Work is also

³³ See Saurina, *Loan Loss Provisions in Spain*, p.19, where he notes: "Loan loss provisions are, therefore, still increasing during the recent recession and have an impact on the P&L of banks, but a much smaller one thanks to the countercyclical mechanism which contributes to the resilience of the whole banking sector. This is the macro-prudential dimension of dynamic provisions."

³⁴ Saurina, *Loan Loss Provisions in Spain*, p.7.

³⁵ See *Commission Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC COM(2009) 207 final*.

³⁶ See *Communication ensuring efficient, safe and sound derivatives markets: Future policy actions COM(2009) 563 final*.

underway to establish the legislative framework for the European supervisory authorities. This will result in a complex institutional framework for the supervision of the European financial sector that is likely to become operational in early 2011. On the other hand, the exact body of regulations reforming micro-prudential standards has not been determined yet and is not likely to be put in place sooner than 2012. The lack of exact differences between micro-prudential supervision and macro-prudential supervision will contribute to the

difficulties for the ESRB to promulgate effective policies. The question arises whether the timing of the establishment of the institutional framework for macro-(and micro-)prudential supervision is appropriate and whether the European legislator should better first have focused on completing the agenda for the reform of the micro-prudential regulations and, afterwards, consider the need for the establishment of a supplemental macro-prudential supervisory system.