

LIBA SIFMA FOA

European Securities Industry briefing on the issues raised in the mandate given to the
European Commission's High-Level Group on EU financial supervision

19 DECEMBER 2008

Table of contents

Executive Summary	3
Introduction	5
(1) Organisation of Supervision; Convergence and Prudential Issues	6
(i) Convergence and Financial Stability.....	6
(a) Would greater convergence have made a difference?.....	7
(b) Limitations of convergence.....	7
(ii) Supervisory Arrangements	9
(a) Supervisory Tasks requiring enhanced coordination	9
Information exchange and coordination of supervision.....	9
Reporting, including deadlines, definitions and formats	10
Setting capital levels for firm/group	11
On-site inspections.....	12
Model approval.....	12
Authorisation, acquisition, enforcement, revocation and restriction	12
Orderly functioning of markets	13
(b) Different models of supervisory cooperation and coordination	14
College arrangements.	15
Lead Supervisor/Consolidating Supervisor.....	18
EU Colleges of Supervisors	19
A European Board of (Banking/Securities) Supervision,.....	20
Level 3 Committees as Agencies.....	21
A Single European Regulator	22
The “28th regime”	23
The Single Rule Book.....	24
Conclusions on supervisory structures	25
(2) Financial Stability	27
(i) Tasks supporting Financial Stability.....	28
(a) Financial Stability Oversight	28
(b) Early Warning Mechanisms.....	29
(c) Crisis Management.....	31
(ii) Financial Stability Cooperation	32
(a) Compatibility with the Global Dimension.....	33
(b) Accountability and Lender of Last Resort	34
(c) Tools and Powers	34
(d) Standards.....	35
(iii) Conclusion	35
EU Legislative Issues.....	37

Executive summary

This paper, prepared by London Investment Banking Association, the Securities Industry and Financial Markets Association, and the Futures and Options Association, presents a preliminary European securities industry view on the issues raised in the mandate given to the European Commission's High-Level Group ("the Group) on EU financial supervision. Some firms are still actively considering their detailed positions, but this paper sets out an agreed European industry consensus on three objectives that should underpin any future change in Europe:

- *Any change should raise standards of supervision in Europe*

Enhancing the quality of standards and their application by supervisors is a higher priority than simply trying to ensure consistency of approach or output. Industry supports high quality, effective regulation and supervision in Europe. Our supervisors need to be better equipped, trained and resourced .

- *Any change should ensure and enhance global coordination and cooperation*

The Group's mandate rightly recognises the global dimension to supervisory and financial stability matters. It should be a priority to ensure that changes in the EU support and further extend cooperation and enhanced standards at the global level. There is a significant risk that responses to the financial crisis will be developed in national or regional isolation.

- *Any change should focus on what is practical and achievable*

The Group should set out clear practical steps, based on close consultation with practitioners, to improve the quality of supervision and financial stability management in Europe. Our paper sets out a range of issues and questions that are central to delivering workable solutions. Time should be given for previous practical proposals, such as those in the Francq report of 2006, to be fully implemented and assessed.

The paper analyses the various options for change open to the Group and makes the following recommendations:

- (1) The EU should press for effective global colleges as the basis for efficient international supervisory cooperation.
- (2) The EU should use consolidated supervisor legislation, and other measures such as more comprehensive and focused Memoranda of Understanding, to deliver better coordination supervision.
- (3) EU supervisors should share information in a more timely and comprehensive manner, particularly with regard to early identification of the potential causes of a crisis. Better use of data gathering and information exchange is the key to improved financial stability oversight.
- (4) EU supervisory and information sharing arrangements should facilitate global cooperation.
- (5) EU arrangements should be adaptable, to allow for the different responsibilities and powers of national authorities.
- (6) EU arrangements should be flexible enough to enable the authorities to act nimbly in any crisis.
- (7) A better EU financial stability mechanism is needed both to facilitate the analysis of new potential system threats and to provide more effective European input into the global arrangements spearheaded by IMF and FSF.
- (8) Issues such as the accountability of supervisors and the role of Lender of Last Resort need to be resolved before considering further structural changes in Europe.

Introduction

The mandate to the European Commission's High-Level Group on EU financial supervision chaired by Mr de Larosière ("the Group") examines structural relationships that affect supervisory practices and financial stability issues, in the EU and globally. We present this paper to the Group to articulate our views on these important topics, analyse the practical implications, and indicate areas where we believe improvements can be made, subject to further careful analysis and impact assessment would be critical before any major programmes of legislative or structural change were agreed upon.

In our detailed comments below we discuss and, where it has not been possible in the time available to analyse them in depth, draw attention to issues that must be considered when analysing better or worse possibilities for delivering the desired outcome of high quality functional regulation and financial stability management.

Broadly, our paper is structured around the three points with which the de Larosière Group was tasked:

- *How the supervision of European financial institutions and markets should best be organised to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors;*
- *How to strengthen European cooperation on financial stability oversight, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks;*
- *How supervisors in the EU's competent authorities should cooperate with other major jurisdictions to help safeguard financial stability at the global level.*

(1) Organisation of Supervision; Convergence and Prudential Issues

Introductory remarks

The first task set out by the mandate is: *How the supervision of European financial institutions and markets should best be organised to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors;*

Additionally, though the mandate asserts that: *"While certain progress in convergence [in supervisory practices and procedures] has been achieved, this progress has not allowed the EU to identify and/or deal with the causes of the current financial crisis".*

In this section of the paper we seek to identify supervisory tasks that need to be considered on a cross border (or even cross sectoral basis) and we set out a range of possible forms of supervisory organisation, identifying issues that need to be assessed if any of these models were to be adopted.

(i) Convergence and Financial Stability

The mandate makes a link between the concept of convergence of practices and the ability to identify causes of the crisis and respond to it with more successful delivery of supervision. The issue has to be analysed carefully before any future models of supervisory or regulatory arrangements are based on this assumption.

The particular concept of convergence has long been more an EU than a global concept and it is notable that international groupings such as the FSF and the G20 have emphasised quality and delivery of standards rather than convergence of practices.

It is important to examine whether there is in fact a relationship between convergence and the ability to identify a crisis at an early stage and to manage it. Would greater supervisory convergence have made any meaningful difference within the EU or globally to what has occurred? Will greater convergence enhance the international or EU response to the crisis and provide greater stability in the future? Or is it in fact possible that greater convergence might have intensified the crisis by making its transmission even more efficient (as noted in section (b) below), or by focusing attention on the wrong issues? Would convergence have been likely to have improved the quality of oversight or decision making?

Irrespective of whether there is merit in more rapid and stronger forms of convergence – and this must be examined analytically and objectively – any proposed changes must factor in the risk that during the period of setting up the new structures and converged practices, the supervisors would be distracted by the need to ensure they can demonstrate convergence. Such pressure weakens the focus and resource that should be spent on the more fundamental task in any convergence project, which is to identify the better or worse practices on which to converge and

to deliver the supervisory function to a requisite high standard. Any proposals to change the structures of supervision within the EU must be based on sound analysis, realistic timetables and resourcing. Otherwise supervisors would expend more effort in ensuring they meet the visible targets of convergence than ensuring that supervision is being delivered to the right standards. . The objective must be to deliver benefits and enhancements that add perceivable value.

(a) Would greater Convergence have made a difference?

Would different arrangements have made any difference? Any such debate is speculative. There are some putative benefits and risks that can be suggested.

Benefits:

Better information sharing – Enhanced early warning signals might have been communicated; recent events provide an opportunity to review what information would be regarded as essential and what information might be seen as valuable but supplementary.

More centralised analysis – Possibly; though perhaps the ability to share and exchange resources in order to conduct analysis might be of more value.

Risks:

Centralised functions – Could have made supervisors more remote from firms' activities; additional layers of bureaucracy could have made the supervisors less well placed to identify risks; there could also have been a risk of a narrower (although unified) frame of analysis for the EU as a whole. Additionally, too exclusive a focus on EU arrangements might fail to identify the influence on events of global imbalances.

A further important conclusion is that convergence of practice or greater information flow on their own would not have addressed failures of risk practice and management and supervision either by the firms or the regulators.

(b) Limitations of convergence

Convergence must avoid creating systemic weaknesses. It is vital that convergence is not interpreted in a way that cuts EU regulation off from the concept that there is more than one way to reach a valid agreed outcome. It would be wrong to force convergence in a way that introduced systemic weakness across all firms and supervisors. It is also important to guard against the twin dangers of dropping to the lowest common denominator or enforcing the highest but overly restrictive, and uncompetitive, standards.

As set out in the mandate, we need to identify the best way of reconciling national competences with effective international cooperation. We need to do so in a way that delivers the optimal results, both for routine supervision in normal times, and for maintaining financial stability and preventing or limiting the effect of crises. In

doing so, we need to find the best balance between arrangements at international level, which will inevitably depend on understandings that depend for their effect on political commitments rather than legal obligations, and arrangements at European level, which may, if Member States and the European Parliament agree, be based on more formal and legally-based cooperation arrangements.

We think that the best way of doing this is to think about supervision and crisis management as a series of tasks, for each of which we need to design the optimal arrangements. For different tasks, the optimal arrangement may differ. For some tasks, it may be best to try to introduce formalised legally based arrangements for cooperation. For other tasks, more informal arrangements may be the best way of encouraging genuine cooperation and consistency.

In any case it is important to have arrangements in Europe that are adaptable enough both to cope with the unexpected, and to work smoothly and effectively with the global cooperation arrangements. Some of the models for more formal European cooperation arrangements that have been proposed would either be over-engineered to cope with the last crisis, and thus not be flexible enough to anticipate, prevent, or cope with the next one; or would be too rigid for non-EU countries to be willing to participate in them. New arrangements need to enhance standards and practices not weaken them or obstruct improvements.

(ii) Supervisory Arrangements

The mandate asks the Group to: *“consider how the supervision of European financial institutions and markets should best be organised to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors”*:

As we indicated in our introduction, in our view this aspect of the mandate has to be considered at the same time as the global dimension, where the mandate also asks the Group to *“consider how supervisors in the EU’s competent authorities should cooperate with other major jurisdictions to safeguard financial stability at the global level”*.

Moreover, these two sections of the mandate need to be considered also in the context of the EU’s, UK’s, France’s, Germany’s, Italy’s, Spain’s, and the Netherlands’ commitment, in the G20 Communiqué, to review the compatibility of national/regional regulatory systems with the globalised financial system. Furthermore, attention must be paid to review of national structures in their own right. As noted by SIFMA in its paper to the G20 Strong national structures must form the foundation for successful international regulatory coordination. Regulators in each jurisdiction should consider whether their national regulatory framework for supervision has kept pace with innovations in financial markets and achieve the enumerated goals of regulation at the national (or regional) level.

(a) Supervisory Tasks requiring enhanced coordination

In order to identify how the supervision of EU firms and markets can best be organised, we need to analyse what tasks supervision performs. Prudential supervision is not a single task, but a series of different tasks. The best way of coordinating activity in relation to these tasks may well vary from case to case.

This section seeks to identify the core elements of supervision that would need to be subject to enhanced cooperation, and the factors that will affect how the arrangements that apply to each cross-border group are best organised.

Information exchange and coordination of supervision

The exchange and pooling of information, and coordination of supervisory activities, including information requests and inspections, are core requirements - to avoid duplication, minimise disruption and cost to the group, and maximise the consistency, coherence, and efficiency of its supervision. It is vital to remove any barriers to these activities.

A variety of factors will affect how the arrangements for each group are best established. The relative influence of these factors will typically vary according to the supervisory function that is under consideration. The factors will include:

- the systemic significance of the financial group in one or more of its countries of activity;
- the complexity of group structures;
- the extent to which the financial group relies upon group approaches and resources;
- the respective expertise and resources of supervisors in different countries;
- the need to have supervisory access to local activities, and the ability to form an opinion locally, without duplicating tasks, either those of the supervisor, or of the financial group

In terms of supervisory coordination, there needs to be a mechanism to ensure both: that requisite information on the activities and risk profile of the group is available to all relevant supervisors; and that this information is gathered and disseminated in the most efficient manner.

Reporting, including deadlines, definitions and formats

Reporting forms the basis of the supervisory process, whether prudential returns, transaction reporting, transparency or market disclosures. All reporting systems are faced with the tension of seeking information that is highly consistent across groups/jurisdictions and the management information data that are prepared and formatted for the individual firm/group's management.

Supervisors need consistent, complete, accurate, and standardised data in order to promote the ability to perform industry wide analysis and peer group reviews. While there will always be an embedded expense to the industry when changing reporting formats, there is a potential gain for firms if we can achieve greater standardisation in international data and reporting requirements. Within the EU there is greater scope for creating consistent reporting formats and definitions than there is at a more international level, which is being pursued through the ECOFIN Action Plan commitment to seek standardisation of reporting formats.

Factors affecting the choice of options would include:

- Degree of consistency of reporting content, format and timing considered desirable/essential/achievable;
- Potential need by individual supervisors to require reporting of supplementary information, depending on the systemic significance of the local entity, or because of the exercise of national discretions.
- The ease with which work on coordination of formats in the EU yields consistent streamlining, rather than a mere aggregation of different national requirements.
- Whether different issues need to be considered with respect to the reporting requirements driven by prudential directives such as the Capital Requirements Directive or the more market related data reporting requirements such as the major shareholding requirements under the Transparency Obligations Directive, public disclosure under the Market Abuse Directive, and the transaction reporting requirements under MIFID. All these directives are based on the principle of minimum harmonisation and as such there has been wide variation of practice within the EU in respect of definitions, reporting deadlines,

reporting formats. From the industry perspective there is no practical or risk management gain from such variation in any of these areas and a potential for reduced operational risk if standardisation can be achieved. Decisions on how best to eliminate these difficulties need to address:

- the reasons for retaining nationally specific requirements (these have been argued for in both the prudential and market conduct fields)
- the importance of enabling firms that operate across the EU to streamline their systems specifications as much as possible in order to ensure the highest quality reliable data
- the extent to which it may be possible to align practicalities more effectively via legislation or other, less formal, protocols.

Setting capital levels for firm/group

Setting the appropriate capital level for a group and conducting the assessments that are necessary in order to determine the capital level (ie Pillar 2 assessments) represent a particular challenge to potential coordinated supervisory arrangements for both groups and supervisors. From the industry perspective lack of coordination can lead to duplicative reporting programmes, re-running models using different assumptions in different jurisdictions and different stress tests for liquidity.

Within the EU, under the current terms of the CRD, decisions on the Pillar 2 assessment can be made by the local supervisor (of an incorporated entity) but proposed amendments to the CRD may encourage greater cooperation between relevant supervisors in drawing up a cohesive pillar 2 capital assessment for a group.

Although there is no legal requirement for a single group-wide assessment to be made, this can be achieved within the existing EU legislation. Moreover, this single assessment can in theory be achieved or approximated on a more international basis. This would depend on a structure that identifies one of the supervisors of the group to act as *primus inter pares*. EU and global coordination efforts should focus on finding such a structure, bearing in mind that although the EU has the legislative ability to ensure a single assessment, this power is in itself limited to group structures that have EU parent companies. Entities outside of the EU (either parent or subsidiaries) or indeed EU entities that are not held by a single EU parent company will remain subject to separate local requirements.

Factors which might affect the organisation or group wide capital assessment are notably similar to the factors which are relevant in decisions relating to on site inspections (see (d) below):

- the need to minimise disruption to groups from duplication of assessments;
- the extent to which the group relies on central processes and risk management tools provided by the group, or whether the group is more decentralised; in the latter case there is an argument for additional assessment at local level irrespective of who performs the assessment;
- the expertise of local supervisors;
- the resources of local supervisors;

- the importance of the subsidiary in the local market or economy;
- whether particular activities, significant in the balance of the overall business of the group, take place in one or a limited number of jurisdictions;

On-site inspections

On-site inspections are one of the most labour-intensive interactions between firms and supervisors. There is much that can be done, through international coordination arrangements, to streamline inspections. Decisions on how to organise this task need to take account of:

- the need to minimise disruption to groups from duplication of inspections;
- the differing expertises of relevant supervisors;
- the resources of local supervisors (including whether local or “home” supervisors would typically outsource such inspections to third party bodies such as consultants/ accountants);
- the importance of the subsidiary in the local market or economy;
- whether particular activities, significant in the balance of the overall business of the group, took place in one or a limited number of jurisdictions;

Model approval

Decisions regarding model approval where firms use models (with restrictions) to calculate their minimum capital requirements, as with Pillar 2 assessment and on site inspection, are an area where greater regulatory coordination would be beneficial. It is an area where legal constraints are common, whether within the EU or internationally. Typically permission must be sought on an entity by entity basis.

However, joint consideration and approval of models which are applied on a unified basis within the group is an important goal. EU and global coordination efforts should focus on its achievement.

Practical issues to consider in taking forward a joint decision making approach include:

- the process should suitably reflect the significance of an activity within a group
- the practical resources of the relevant supervisors.
- the need for firms to streamline model approval, and use as consistent a model as possible across jurisdictions;
- the importance of the subsidiary in the local market or economy;
- the extent to which a model relied upon local data or sought to reflect idiosyncratic local market behaviour;
- any exercise of national discretions;

Authorisation, acquisition, enforcement, revocation and restriction of activities

Globally there is a wide variation in the powers vested in supervisory authorities. However it is important that the exercise of supervisory powers as well as supervisory practices should take account of the need to coordinate and understand the wider group picture, even though decisions relating to authorisation, restriction

of activity, acquisition and merger or revocation will, for legal reasons, have to take place within the jurisdiction in which the entity in question is incorporated. It is also important to note that some regulatory sanctions such as restriction of activities or removal of senior management may have civil and/or criminal law consequences or obstacles.

In the EU, and on a cross sectoral basis, applying to banking, securities, insurance, and UCITS, there has already been considerable streamlining of powers particularly pertaining to change of control (which have much commonality with authorisation processes). The changes were made recently in the Directive commonly termed "The Mergers and Acquisitions Directive." The Directive does not however harmonise supervisory powers of intervention or sanction.

Decisions on which of these arrangements to apply can be made collectively taking account of:

- the need for firms to streamline activities as consistently as possible across jurisdictions.
- the importance of the subsidiary/activity in the local market or economy
- any exercise of national discretions.
- The importance of applying a consistent approach to authorisation and (in particular) revocation or restriction decisions implies that the collegiate responses are important and that, to the extent possible, the parent supervisor should have a strong voice within the college.
- Nevertheless, in the field of supervisory powers the final decision making power will almost certainly always rest with the local supervisor. This might mean that the local supervisor will not act in accordance with the views of fellow supervisors, due to concerns about the potential risks to the jurisdiction in which the specific entity is incorporated. However, it is important to find the best arrangements, at EU and global level, to ensure that the decisions the local supervisor reaches and the actions it decides will take account of the concerns and interests of the parent supervisor and the wider college of supervisors and it is likely that amendments to the CRD will reinforce this view. Such an outcome can promote greater consistency of supervisory approach across a group and greater understanding of the scope and nature of the group.

Orderly functioning of markets

The regulation and supervision of the functioning of markets is organised differently from prudential supervision, reflecting the fact that it is strongly rooted in the conduct of business by actors who are located in particular jurisdictions and operating in particular markets, and who therefore need to be supervised in relation to these activities locally, taking account of local laws and market practices (in the EU under MIFID, for example, supervision of the conduct of business of branches within the branch jurisdiction is conducted by the local regulator). The coordination of these regulatory activities is effected by a network of regulators – IOSCO at global level, and CESR in the EU, which promotes consistent standards and practices, which in the EU are complemented by the detailed legislative underpinning of MIFID and also includes continuing to work towards mutual recognition with non EU countries.

(b) Different models of supervisory cooperation and coordination

This section considers different options for models of supervisory cooperation and coordination and seeks to identify issues and questions that are relevant for the range of systems – whether they are more centralised or more devolved. Such issues need to be subject to careful analysis and assessment before any far reaching decision is made on supervisory structures, whether at EU or global level.

In assessing the range of structures on offer, there are a variety of factors that must be addressed:

- a) **Compatibility with the global dimension:** as discussed above, priority must be placed on the need for any EU model or supervisory arrangements to work effectively with and support, as appropriate, global efforts to enhance supervisory coordination and oversight of international groups.
- b) **Accountability and Lender of Last Resort:** to whom will the supervisory structure(s) be accountable? How will political independence be assured? How will the Lender of Last Resort function be decided? These three questions are closely related, so are presented together. These issues are the most political.
- c) **Supervisory Powers:** to what extent would different structures of cooperation exacerbate or accommodate any differences or gaps between the powers and responsibilities of national supervisors in individual Member States?
- d) **Supervisory Standards:** to what extent would different structures not only drive consistency of proportionate supervisory outcomes, but also raise standards and practices? To what extent would different possible models enhance or hinder greater coordination and cooperation in relation to each of the supervisory tasks which are discussed in the previous section?

Aside from the four factors noted above, but as a preface to the examination of some of the different models of cooperation, it is worth noting the role played by the EU legislative framework itself.

There are opportunities for EU legislation:

- To remove barriers between EU supervisors communicating and sharing information (in both directions) with supervisors in third countries. If there are any remaining intra EU obstacles that would be an urgent legislative objective.
- To ensure that EU supervisors are able, voluntarily if it appears to be for the benefit of the supervisory oversight of and control of the group, to delegate tasks to non-EU supervisors.
- To ensure that there are no damaging differences of supervisory powers between different Member State jurisdictions – quite apart from any analysis of supervisory arrangements, this is a stocktaking exercise that should be carried out, and has formed part of the ECOFIN Action Plan. Legislative amendments could legitimately follow a due better regulation assessment process.

There are also risks that EU legislation may create:

- Obstacles to communication between supervisors and other relevant authorities within the EU, and between EU authorities and relevant authorities in third countries.
- Rigid structures that are so highly engineered that third country authorities find it difficult or undesirable to cooperate.

There would be an additional risks in any model of supervisory cooperation/coordination model that was based exclusively on the Eurozone. It is likely that any such model would reflect political imperatives if it were adopted, but it cannot be supported on analytic grounds. Currency zone is not intrinsic to the delivery of prudential standards and supervisory implementation and nor can it ameliorate national issues with respect to corporate and insolvency law that are linked to the delivery of many financial stability functions. A sub-grouping within the EU would create an unnecessary layer of added bureaucracy.

Models of Supervisory Cooperation

Proposals for more integrated EU arrangements have focused in particular on the international groups, and have included:

College arrangements.

Supervisory Colleges are the globally agreed mechanisms, endorsed by the G20 Communiqué, for improving coordination and the quality of supervision while reconciling national accountability with international cooperation at global level.

The college of supervisor model is not new and has facilitated the exchange of supervisory information and cooperation for several decades. Within the EU gateways to facilitate exchange of information and cooperation agreements, both inside the European Union and with authorities outside the EU, have existed at least since the Second Banking Coordination Directive (1989). International cooperation has been facilitated by the Basel Committee of Banking Supervision which has issued and revised guidelines for cooperation between home and host supervisors on an international cross-border basis since the 1970s. Over time, and with the gradual improvement of national legislations, the ability to share increasing amounts of supervisory information has been facilitated.

Colleges are a model for delivering cooperation and coordination based first and foremost on exchange of information. By pooling information the relevant supervisors are able to form a global view of a group, identify the significant areas of activity, of emerging risks and strengths. Colleges can then facilitate cooperative supervisory activities, depending on whether the relevant local supervisory authorities have the vires to participate or allow host state involvement. Cooperative arrangements do not have to be static but can develop as circumstances change (either of the financial group or of its supervisors). They thus provide, ready to hand, a proven means of delivering immediate improvements. If local legislation facilitates it, it is in fact possible to deliver many if not all of the supervisory tasks discussed in the preceding section on a holistic group wide basis, even though globally there is no legal framework that can mandate this outcome.

Legal basis of colleges

In analysing the strengths and weaknesses of the college model we recognise that the concept of colleges is not supported by all commentators. The main criticisms of college arrangements are that they lack legal foundation and consequently lack "teeth", whether in decision making or in discrepancies in terms of the authorities powers to act. Additional criticisms relate to lack of full information sharing. It is important, however, to identify the circumstances in which such criticism is valid.

Lack of a legal basis is the core virtue of the college model, not its weakness. The college model is the only arrangement that can deliver supervisory cooperation in circumstances where there is no common legal framework to provide a legal basis. The college model is a voluntary structure precisely because there is no overarching global jurisdiction that can mandate powers or responsibilities on a global basis. It cannot impose decision making functions, or insist that information flow over-rides local legal restrictions. Globally, no body can do that. Within the EU there are other structures that can be explored, and which are discussed below, to meet these needs, depending on the degree of political commitment that is achieved.

Commentators who are concerned at the lack of binding legal powers within colleges (whether this relates to setting overall group capital, approval of models, reporting functions, etc) overlook the essential fact that there is no significant globally active financial group where it would be possible to impose such powers on a group wide basis.

Having said this, there may be supervisory tasks or areas in which a re-ordering of EU supervisory arrangements to deliver stronger coordination or consistency or centralisation at EU level (in which context the EU sub-group would cooperate through the colleges with third country supervisors) could achieve better cooperation and coordination within colleges. We analyse the distribution of powers and roles within the EU in the context of our discussion of the concepts of "Lead Supervisor" or "Consolidating Supervisor" below.

The concept of supervisory colleges is being introduced into EU legislation at present via amendments to the Capital Requirements Directive. Based on the Commission's proposal, EU colleges are to be set up under the aegis of the "Consolidating Supervisor". Structurally there is a difficulty with this proposal, as the composition of the global group of supervisors may bear little relation to the composition of the relevant EU supervisors. The more the EU supervisors establish EU rules of organisation (eg using CEBS as a binding arbitrator in case of disagreements) the less likely it is that other relevant third country supervisors, who may supervise parent entities for the group, and/or other major subsidiary entities of the group, will wish, or even be able, to participate in the "EU College" on terms that have been set up in the EU with no consideration of how best to coordinate with other jurisdictions. This could easily lead to the creation of parallel colleges where third country jurisdictions come to global agreements on how best to establish colleges which would bypass the EU model. EU supervisors would effectively have to participate in parallel global structures as well, but the result of such bifurcation between the EU and the rest of the world would be reduced efficiency and effectiveness, and possibly an exacerbation of risk.

We conclude that when making decisions on the EU framework, it is necessary to ensure that it can function effectively with other global arrangements. EU decisions on its supervisory structures need to be able to feed in effectively to international efforts to deliver effective oversight, analysis and assessment of globally active financial groups.

Memoranda of Understanding (MoUs) and the operation of colleges

Memoranda of Understanding are not legal documents. They have no power of enforcement. However, MoUs deliver the rubric by which each college will operate. Within the EU MoUs have been used in a number of supervisory areas. Different views exist on whether MoUs benefit from being wholly standardised (securities supervisors have tended to go in this direction) or whether they are better tailored to fit the relationships between the specific authorities in question (this experience has been more typical in banking supervision). MoUs do, however, provide clarity of expectation in terms of what can and cannot reasonably be achieved in the context of the specific circumstances of the individual financial group and its family of supervisors. Familiarity with MoUs has increased considerably over the past twenty years and authorities are likely to have improved their ability to state their practical needs and requirements in the MoUs much more effectively than they did in the past. This skill, doubtless, will continue to improve over time. It is also important to bear in mind the extent to which international commitments, building on the G20 Communiqué, can be used to provide a political reinforcement to the cooperation arrangements set out in MoUs.

Summary of Colleges of Supervisors

- a) Compatibility with the global dimension:** Colleges of supervisors are the pre-eminent agreed model for ensuring more effective coordinated oversight, analysis, assessment and coordinated supervisory programme at the global level. The financial crisis, and the G20 commitment, provides new opportunities for political commitment to make better use of them, in the EU and globally.
- b) Accountability and Lender of Last Resort:** Colleges do not impinge on accountability and LOLR functions, which remain unaltered by college arrangements. More effective coordination between relevant supervisors through reinforced colleges should reduce the risk of LOLR functions needing to be used.
- c) Supervisory Powers:** Colleges accommodate differences in powers more effectively than other models. Colleges cannot alter supervisory powers or responsibilities, but the college model utilises all options in the most flexible manner for different supervisory tasks. Cooperation arrangements can be facilitated where local legal requirements allow, and global commitment offers the opportunity for new impetus.
- d) Supervisory Standards:** Colleges cannot impose standards nor can they mandate enhanced convergence (in whatever manner convergence is defined). However, by mutual exchanges of experience and supervisory culture, colleges can create a cooperative and non-threatening environment to promote cross fertilisation of ideas and an overall raising of standards.

Lead Supervisor/Consolidating Supervisor

In the EU context, the terms “Lead Supervisor” and “Consolidating Supervisor” refer to situations where there is a competent authority responsible for the exercise of supervision on a consolidated basis of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies. The concept can be confused with the College model because a group of supervisors are involved. The crucial point is that all supervisors are located within the EU and subject to EU legislation. The Consolidating Supervisor is the supervisor of the parent company of the EU group. Thus the supervisors of all the subsidiaries and branches of the EU entity which are themselves located in the EU participate in this cooperation model. Because the EU provides a legal framework, it is feasible to discuss the distribution of powers, tasks and responsibilities between relevant EU supervisors and therefore the Consolidating Supervisor is the authority to whom certain supervisory tasks are allocated on behalf of the whole group – including all EU incorporated subsidiaries.

Criticisms that have been directed at the Consolidating Supervisor model have included:

- Failure to delegate powers as Member States where subsidiaries have major systemic significance will not accept regulatory decisions that are taken in the Member State of the parent company. In effect this argument relates to the fact that not all powers have yet been delegated to the parent supervisor of the group. But the core issue at stake is not a failure to trust a supervisor located in a different jurisdiction but the need to protect the systemic interests of the Member State which is host to a systemically significant branch or subsidiary. There is a balance to be struck and this is one where an enhanced approach to Financial Stability within the EU may promote much greater possibilities for delegated decision making in the supervisory sphere.
- Failure to impose decisions on a group. This issue is in fact a subset of the delegation of powers. The Lead Supervisor model **can** deliver a clean clear cut decision making model but it can only do so for those tasks and responsibilities where there is political agreement to permit this.

The Consolidated Supervisor model is the model that most accurately reflects the degree of political willingness within the EU to delegate and cede authority to other jurisdictions. At the same time it is the model that can most pragmatically identify, task by task, which functions can be most practically and efficiently delivered on a group wide basis.

Consolidated supervisor arrangements can also be supplemented by specific EU legislation or other coordination arrangements in relation to specific tasks to give greater alignment of EU requirements. Examples are, in the supervision area, the work that is being conducted to align reporting formats, which could result in either CEBS standards or legislation, and in the financial stability field the recent agreements on deposit guarantee alignment.

Summary Consolidating Supervisor

- a) **Compatibility with the global dimension:** Reasonable. The consolidating supervisor is likely to be a main interlocutor in any global arrangement but this would not exclude other key EU supervisors as necessary.
- b) **Accountability and Lender of Last Resort:** The LOLR is not formally affected, but the question of accountability is important as tasks and some powers can devolve to the consolidating supervisor.
- c) **Supervisory Powers:** Supervisory powers are affected by this model and the identification of which powers and the degree to which they are modified can be dealt with on a very pragmatic case by case basis.
- d) **Supervisory Standards:** This model would certainly deliver greater consistency of approach across individual financial groups. Although some decision making mechanisms are mandated, so are the means of achieving a consensual agreement if at all possible, so the opportunity for mutual exchange of supervisory experience and practice is fostered.

EU colleges of supervisors

The Commission proposal for amendments to the CRD creates the concept of an EU college which functions as a creation of the Consolidating Supervisor. There is a weakness to this structure, which is discussed above in the section on global Colleges. The difficulty is that not all EU presences of a financial group will necessarily be captured within the Consolidated Supervisor structure. For example, a third country branch would not be captured. The EU college structure can (theoretically) address this issue by voluntarily inviting the supervisor of the third country branch (assuming this supervisor is not already involved). However the relationship of the EU college to the rest of the international community is left very unclear.

The Commission proposals create a detailed system for cooperation within the college. Some of these proposals are entirely practical and welcome but others (such as mandating a dispute resolution mechanism) are highly ambitious and would be extra territorial if imposed on third country regulators. Although the EU college might be influential in cases where the parent of the group was European, it is not likely to be the case where the group has an ultimate third country parent entity. Moreover, even in cases where the parent company is located in the EU, the more significant third country regulators (particularly when they are host to substantial presences) are unlikely to be willing to enter into highly engineered college structures which they have had no hand in forming and which may or may not have any consistency with agreements and practices drawn up at the global/G20 level.

The EU college may well be a useful overlay for the Consolidated Supervisor model – further encouraging and structuring relationships between EU supervisors who are involved in the Consolidated Supervisor's grouping. However, its main utility may prove to be for more regional groups that are active purely in the EU and where the relationship with non-EU jurisdictions is not a factor. However the EU College proposals are not useful when assessed against the requirements of global cooperation. Nevertheless, it is important to consider the extent to which EU legislation has (and could increasingly in the future though the concept of

consolidating supervisor) create a legal foundation for elements of cooperation, task sharing, delegation between EU supervisors who may be coordinated and mediated as necessary by Level 3 Committees.

Summary

- a) **Compatibility with the global dimension:** Limited, and in the case of global groups likely to encourage the creation of less effective parallel systems of supervisory colleges across the globe.
- b) **Accountability and Lender of Last Resort:** As with other college mechanisms this is broadly unchanged, but CEBS is given a stronger hand to resolve disputes. Arguably therefore accountability is split between the individual supervisor's accountability and governance and that which applies to CEBS. The LOLR function is not resolved.
- c) **Supervisory Powers:** Supervisory powers are not changed or amended, but there is a degree of pressure to facilitate cooperation and voluntary delegation.
- d) **Supervisory Standards:** Formally this approach does not address standards but it coexists with the CEBS structure and creates an arrangement where supervisors are increasingly exposed to each others' practices and have the opportunities to develop new and better standards based on practical experience. This convergence could then be adapted into EU law, where needed in relation to particular tasks.

A European Board of (Banking/Securities) Supervision,

A European Board of Supervision exercising certain powers over the supervision and financial stability arrangements for the European sub-groups of the main international firms, and which override national powers. This model would be potentially analogous to the European System of Central Banks, but its focus would be supervision as opposed to monetary stability. It is not clear that a monetary policy model would translate well to the more micro field of supervision, although there may be merits in this type of structure in the closely related area of financial stability. The capacity to deliver a range of tasks on a consistent basis (whether the range of reporting demands or group capital assessment) would be likely to be enhanced and it is also possible that an EU board might have a stronger EU voice in international negotiations – though the means by which this single voice were achieved would be important and quite possibly difficult to determine. Any rigid decision making process would be likely to be politically controversial, especially if, for example, it were based on one Member one vote, given the range of development or significance of the financial sector in different Member States.

Summary

- a) **Compatibility with the global dimension:** Essentially an EU focused structure, whose relationship with the global context would need to be very carefully considered and iterated – particularly in cases where the ultimate group parent company is not located in the EU.
- b) **Accountability and Lender of Last Resort:** Accountability structures would need to be determined – different structures could be envisaged. It is likely that decisions on LOLR would be needed before such a system could be put into place.

c) Supervisory Powers: Supervisory powers would be amended and would be likely to be harmonised with main powers accumulating to the Board. A particular disadvantage of the this model by comparison with the College or Consolidating Supervisor model is that it is an 'all or nothing' model, without the scope for differentiated allocation of responsibilities in relation to the different tasks of supervision.

d) Supervisory Standards: Formally standards would be likely to appear to be consistent across the EU. In practice local variation would still be possible. The ability to make such variation transparent and to challenge it might be weaker in the face of a more centralised authority as the dispute would in effect be "internal". Standards would run the risk of being arbitrarily adopted as opposed to developed over time based on an analysis of a range of good and equivalent approaches through the EU: if this were to happen, risks could be exacerbated, not reduced.

Level 3 Committees as Agencies.

The conversion of the Level 3 Committees (CEBS, CESR, CEIOPS) into European Agencies, which derive powers from and are accountable to the EU institutions. Much would depend on the precise articulation of powers vested in the new Agency(ies) i.e. whether decision making, or peer group review, or inspection powers or policy formation powers were granted to the Agency.

Summary

a) Compatibility with the global dimension: As in the case of the European Board of Banking Supervision idea, essentially an EU-focused structure, whose relationship with the global context would need to be very carefully considered and iterated – particularly in cases where the ultimate group parent company is not located in the EU.

b) Accountability and Lender of Last Resort: The fact that Agencies were accountable to EU institutions means that LOLR may not be resolved but accountability mechanisms would have to be determined and should have reference to Member States through their representative bodies (ie ECOFIN). The potential for confusion and thereby increased risk arising from cross-cutting accountability to national authorities and EU institutions is very great, and would need to be carefully considered.

c) Supervisory Powers: Again much would depend on the detail as to whether powers would be made more consistent across the EU. This would not necessarily be the case, but some powers might be granted to the Agency, thus side stepping local caveats. Much would depend on precisely how the Agency status varied the allocation of powers between Member State and EU authorities. A particular disadvantage of the EU Agency model by comparison with the College or Consolidating Supervisor model, with the Level 3 Committees operating as networks, is that there would be less scope for differentiated allocation of responsibilities in relation to the different tasks of supervision. A further disadvantage relates to the fact that CESR, whose main responsibilities relate to conduct of business and markets supervision, needs to be able to take account of local variability of market practice and legal structures needs to a much greater extent than CEBS.

d) Supervisory Standards: Possibly closer to the college method of exposure to ranges of supervisory practice and combined with time to identify carefully the good available practices there should be scope for an overall rise in supervisory standards across the EU, monitored and mediated as necessary by the Agency.

A Single European Regulator

The notion of a single EU regulator for the European sub-groups of the main international firms is one of the more far reaching concepts that might be proposed – analogous to but going further than the creation of Agency status for Level 3 Committees. A summary of issues to be considered/addressed would include:

- Would establish a single approach to supervision and enforcement and also mean that only one approach was taken to such issues as early intervention and other supervisory powers and supervisory tasks such as reporting (conduct of business as well as prudential), single capital assessments for groups etc.
- Would introduce an additional layer of bureaucracy with respect to the relationships between the central/local delivery of tasks, which might reduce responsiveness to risks, thereby increasing risk overall. From the firms' perspective the multiplicity of relationships would be likely to be reduced and issues such as single treatments for reporting/models etc ought to reduce bureaucracy as policy making, finance, audit, and training functions could be rationalised.
- Would remove policy formation and analysis further from the direct activity of firms.
- Local inconsistencies in supervisory approach would remain a possibility – given that the immediate supervisory relationship would need to be delivered on a national basis, even if the “local” supervisor was in effect now a subsidiary or branch of the “single supervisor”. It would therefore be harder to challenge inconsistent approaches developing in different areas.
- Political feasibility and transitional arrangements: the legislative and treaty changes would be more profound for this arrangement than for any other.
- Timing, funding and resources: the availability of these three factors will have a significant effect on the quality of the standards and supervisory practices. These are long term processes, and realistic goals (which may outlive the lifetime of any individual government, parliament or commission span) would need to be set in order to ensure that the management of the supervisor did not concentrate on easily deliverable targets rather than meaningful improvements of supervisory standards.

Summary

a) Compatibility with the global dimension: As in the case of the European Board of Banking Supervision and Level 3 Agency ideas, essentially an EU-focused structure, whose relationship with the global context would need to be very carefully considered and iterated – particularly in cases where the ultimate group parent company is not located in the EU. This model has, even more than other structurally centralising models, the potential for resources to be diverted at a time of crucial vulnerability from effective global cooperation, or even effective cooperation at EU level, into legalistic or bureaucratic or political issues.

b) Accountability and Lender of Last Resort: Accountability mechanisms would have to be established, but the single regulator concept would depend on the EU Lender of Last Resort function having been decided upon as the relationship of the normal supervisory function to the crisis/resolution functions would need to be established in advance of any new EU structures.

c) Supervisory Powers: This question would need to be resolved as part of the constitution of a single supervisor.

d) Supervisory Standards: Regarding the establishment of standards and practices, EU supervisors would still have to find methods of identifying the appropriate standards and practices to apply. It would also have to be determined whether different sub-sectors of firms required different practices or standards of supervision – and also whether this possibility would create legal or constitutional difficulties in any jurisdiction. Such matters can be more easily managed if the focus is on how to cooperate most effectively, as in the College and Consolidating Supervisor models, without the complication of devising new EU legal arrangements.

The “28th regime”

The so called “28th regime” is a model that would create a single system of supervision for large internationally active firms, but one which would leave smaller domestic or regional firms to be supervised according to existing national/coordinated practices.

Issues that this system would have to address:

- How to define which firms went into which category. Where would the boundary be drawn? Would the decision be at regulators’ discretion, or would firms volunteer? Voluntary allocation would meet the test of equality of opportunity, but regulators might have strong views about which firms they would or would not want to be included in which regime.
- Would the distinction be purely one of regulatory practice, or would it involve rules as well; where would the boundary be drawn?
- How would the training of regulators in converged practices be resourced and funded?
- How would the costs involved in adjusting to converged supervision avoid becoming a barrier to competition and effectively limit access to the Single Market?
- How would the differential in costs between converged supervision and local practice avoid becoming a barrier to competition in each domestic market?
- How would supervisory practices for local and international firms evolve over time? How could regulatory practice in each keep up with market developments while avoiding getting out of step with each other?

Summary

a) Compatibility with the global dimension: As in the case of the European Board of Banking Supervision and Level 3 Agency ideas, essentially an EU-focused structure, whose relationship with the global context would need to be very carefully considered and iterated – particularly in cases where the ultimate group parent company is not located in the EU.

b) Accountability and Lender of Last Resort: The same questions would arise for this system as for single EU supervisor on the basis that supervisory powers would no longer align with the jurisdictions in which the regulated entities were incorporated.

c) Supervisory Powers: Powers would be standardised (though with the continued potential for local variation which may not be transparent) at the “EU international” level but could diverge markedly from continued national powers.

d) Supervisory Standards: Divergence between the pan EU approach for the systemically significant groups and the smaller regional or domestic groups would be expected to emerge over time.

The Single Rule Book

The concept of a “Single Rule Book” (SRB) is commonly mentioned but nowhere is it defined.

Clearly, although a number Member States transpose Directive text directly into national rules, Directives are not perceived as having delivered a single rule book. In Treaty terms (Article 249) Directives are addressed to Member States in order to bring about a desired outcome. It is for Member State discretion to determine how to achieve these outcomes. The Directive process requires at national level (a) an interpretative process for each Member State/Competent Authority in order to express the directive in terms that the regulated entities can comply with and (b) processes, practices and behaviours that the competent authority must adopt in order to enact its obligations and which must be in conformity with national law.

If a Single Rule Book is created in order to avoid the need for any national transposition mechanisms it must still find a process to deliver a common EU view of how national implementation shall be delivered. It must address both supervisory practice as well as implementation practice by firms. Yet even setting aside any debate on how Directives should be implemented, it is worth noting that even if there were “a single rule book for Europe”, there would still be a lot of variation in what supervisors understand those rules to mean and how they think they should be put into operation in local markets. Hence the “national variation” created by the Directive process is not necessarily removed even if there is a Single Rule Book, or if the EU legislative text is delivered as a Regulation and not a Directive.

Summary

a) Compatibility with the global dimension: Working on the assumption that the EU does not develop policy in an isolationist manner this ought not to be a concern.

b) Accountability and Lender of Last Resort: Accountability mechanisms do not need to change as they would remain as at present. Similarly LOLR issues would not need to be resolved.

c) Supervisory Powers: If Supervisory Powers were not standardised across the EU, then the single rule book could be expected to have strong variations of outcome at times of greater stress in the system. National discretions could be eliminated, although recent experience shows that Member States have been reluctant to eliminate all discretions in the CRD, so it is possible that local

discretion, or even variation of powers, may still be permitted even in a single rule book approach.

d) Supervisory Standards: Its advocates suggest that a Single Rule Book would deliver consistent standards. In fact divergence at local level would remain possible. A Single Rule Book may or may not enhance standards – it is not inevitable that there would be enhancement or deterioration across the board.

Conclusions on supervisory structures

Colleges are the most appropriate model for global cooperation and coordination and must be supported at the EU level by an intelligent application of the Consolidating Supervisor model, and by other specific EU legislative or other coordination measures to align the performance of specific supervisory tasks within the EU where needed. This recommendation is based on the fact that the college model is the only template that can operate effectively at global level without an underpinning legal basis, whilst also providing room for effective pan-EU coordination and cooperation. It can deliver the most adaptable, pan-EU and globally consistent outcomes, provide least distractions from an overall increase in standards and ought to be the least subject to the risk of over-engineering and thus exacerbation of the transmission of risk. In the absence of a single global or EU regulator which can call on consistent powers in all jurisdictions and territories, the college model provides the only long term solution to ensure that relevant supervisors internationally can come together to ensure information flow, whole group and market risk analysis and identification of items of risk and potential concern.

There is a clear necessity for there to be a global initiative to improve and agree coordination of how colleges should operate: scope of membership, exchange of information, frequency of contact, subjects on which to concentrate and allocations of responsibilities (including whether or not the college wishes to be open to the possibility of cross border delegation of tasks). In other words there is a need for the bodies that oversee members of colleges to agree what they will address and also agree the rubrics for how they may achieve this best. With this political impetus, embodied in the G20 Communiqué, and in which the EU should play a leading role, colleges can do much more to coordinate international supervision than they have in the past.

There is no model of supervisory structure that can deliver, at global level, standard levels of capitalisation across a group, distribution of liquidity, approval of models, review of business strategy, early intervention, or other enforcement (or revocation) and post crisis resolution powers on a legal basis. The EU arrangements need to facilitate this outcome on a global level.

EU arrangements are important because the EU provides a regional framework on which to build that can in turn improve global arrangements. Some of the desired, enhanced regulatory outcomes can be sought on a regional EU basis as there is a framework on which to build. But at a time when we need to create a high quality international product, we suggest that EU regional arrangements should be determined, task by task, to seek the optimal way of reconciling EU coordination

with global coordination, rather than by seeking a more formal institutional arrangement that could not be so adaptable to what is needed. Europe can best show leadership to the rest of the world by applying arrangements that best meet this need.

Where there is an evidenced need for additional EU-level coordination arrangements, the existing EU legislative arrangements, either directly or through consolidating supervisor provisions, provide the best way of doing so in a targeted way, and also provide a well-understood legal basis to do so where needed.

We challenge the assertion that colleges are flawed because they lack a legal basis. There is a clear distinction between the role and function of a college – which is to ensure coordination, information exchange, and most efficient performance of tasks, whether at global or EU level - and a transfer of powers and responsibilities between jurisdictions as is possible within the EU.

To summarise, the risks inherent in more formalised arrangements for cooperation focus on:

- exacerbation of risk as a result of straitjacketing;
- remoteness of supervisors from the activities which give rise to risk;
- over-emphasis on EU-level rather than global risks;
- more focus on building structures and seeking convergence within the EU than on making sure that the supervision itself has the quality that is needed;
- incompatibility of EU with global cooperation arrangements, resulting in the need for a separate, parallel structure of cooperation between EU and third country supervisors.
- The 29th regime may also raise issues of competitive imbalances or constitutional viability in some jurisdictions.

(2) Financial Stability

Introductory remarks

The Mandate asks the de Larosière Group to consider: *How to strengthen European cooperation on financial stability oversight, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks;*

As before, the mandate asks the Group to *consider how supervisors in the EU's competent authorities should cooperate with other major jurisdictions to safeguard financial stability at the global level.* We welcome this global dimension, which is also consistent with the G20 members' expressed commitment to review the compatibility of national/regional regulatory systems with globalised financial system.

Given that the mandate identifies three broad areas (financial stability oversight, early warning mechanisms and crisis management), this section of the paper considers the tasks that are associated with Financial Stability operations under these headings. All the issues relevant under each heading must also be considered in the cross border and cross sectoral context. We then consider models which might promote an enhanced delivery of these tasks, leading to a concluding section which emphasises the issues which will require particular analysis before any structural decisions are contemplated. In other words, in order to identify how European cooperation on financial stability can best be organised, we need to analyse, as in the case of supervision, what tasks these activities involve, and to identify in each case the best balance between global, national, and EU coordination, in order to achieve the overall objective of European and global stability.

Consistent with our examination of supervisory issues in Section (1) above, we place central importance on the need for there to be effective and efficient global solutions and for any proposals adopted to meet the test of pragmatism and practicality.

In this section we also touch on the cross sectoral dimension. In summary the cross sectoral dimension presents conceptually a similar range of issues to those faced when analysing cross border arrangements. It introduces a new range of competent authorities, intervention, crisis and resolution frameworks. Although authorisation and supervision issues may be harmonised on an EU level within a sector, the approaches between sectors can be very different – often crucially so in order to reflect the risks inherent. But at a more macro level there is an increasing pressure to gain a comprehensive view of where risk may be located and understand its transmission mechanisms and how it may be mitigated. The relationships between the financial sectors may be, as yet, not wholly understood. In any case, it can be summarised as an additional dimension of complexity to take into account and it is essential to ensure there is greater understanding and management of risks and not simply enhancement of contagion capacity, whether cross border, cross group, cross market or cross sector.

(i) Tasks supporting Financial Stability

(a) Financial Stability Oversight

Macroeconomic and macroprudential information gathering, sharing and analysis. At present there is no system in place that enables supervisors to achieve a high level, across the board view of systemic risks.

Issues to consider, therefore, to address that void include:

- Ability for macro prudential data to be gathered and communicated efficiently between relevant authorities.
- There may be legal obstacles to such transmission that need to be identified and resolved, although within the EU gateways have received a lot of attention in recent years. It may be necessary to ensure that EU authorities have a better ability to communicate effectively with the appropriate non-EU counterparts.
- Need to ensure not only that data gathering was comprehensive, and where necessary, sufficiently granular but also that data gathering covers all relevant sectors and jurisdictions.
- Tasks falling in the field of macro oversight and analysis could be conducted either by a single central body or through an efficient system of exchange in order to build a global picture. It is hard to envisage an effective global analysis without some degree of central coordination which might therefore be best delivered by one of the existing international institutions.
- Purely EU arrangements would tend naturally to focus on the EU dimension, and taken alone would not be able to provide a complete picture, and thereby expose the EU to greater risk. However, it ought to be possible for EU mechanisms to feed into the global arrangements. National arrangements would also continue to be necessary in order to deliver information to regional and global levels.

Crisis simulation exercises: improving such exercises rely fundamentally on improved cooperation between relevant regulatory authorities.

- Again there is an essential need for information flows to be effective between authorities.
- It is important to consider that simulation exercises are unlikely to mimic or predict any actual crisis situation, so there is a risk of complacency or of “blind spots” developing. However, such simulation exercises are vital in order to achieve that necessary working level degree of familiarity and expertise in relevant bodies of how to activate the requisite mechanisms and cooperate smoothly and efficiently with the appropriate authorities.
- Tasks that relate to pre-planning and coordination in the event of a crisis occurring can be delivered with more certainty at EU level than is likely to be possible at global level as the EU has a legal framework that means it is capable of ensuring that any requisite legal powers are provided and legal barriers are removed.

- Crucially, 2008 events have shown the unpredictability of issues that arise. Countries will need to avoid over-engineering crisis responses, and retain flexibility to react quickly to very rapid events.
- Any use of EU legal powers to coordinate and pre-plan must be very carefully considered to ensure that it facilitates the ability to manage risk and does not, by limiting Member States' freedom of action, add to instability rather than control it.

(b) Early Warning Mechanisms

Early intervention tools and triggers for crisis response: At present there is no global consensus on the most appropriate or effective early intervention tools nor on what indicators can or should act as triggers for crisis response. Similarly no definitions of "crisis" or "failed market" exist.

Triggers for early intervention or crisis response Trigger signals might relate to solvency (eg breach of a minimum capital requirement) or liquidity data or perhaps other market indicators (eg share price).

Issues that need to be considered if there is to be greater coordination and standardisation of trigger events will include:

- Consideration of whether the trigger regime should be "hard" or "soft": will the trigger indicator automatically require regulatory intervention, or will the authorities have discretion in when or how to intervene. Broadly there is a trade-off between apparent legal certainty (although mandatory mechanisms, particularly if they are based on highly transparent/visible signals may well exacerbate risk because of the risk that they become self-fulfilling) and the ability of the regulator to intervene in a measured way taking account of the particular circumstances of the case at a moment where there may still be the potential to stave off a more full blown crisis.
- Consideration of whether a trigger event in one entity could be seen on mandatory or discretionary basis as a trigger event for all other EU entities/presences of that group.
- Consideration of whether the trigger signal is indeed a reliable indicator in all jurisdictions of difficulty at firm or systemic level.
- Consideration of whether the trigger should apply (ie be exhibited) at individual firm or group level and if the triggers are attached to individual entities what the mechanisms are for the rest of the group entities being affected (or ring fenced).
- Inconsistencies between EU Member States can clearly be resolved if there is the political will, backed up by appropriate analysis. Greater coordination at the EU level cannot, though, remove inconsistencies of approach at a global level and as many significant groups are active globally, an EU treatment may be of limited value and if so care needs to be taken when agreeing the level of priority of greater consistency or coordination, and the focus may need to be on seeking effective coordination at global level.
- It is possible that agreement might be achieved at global level although the global dimension might bring with it a wider range of factors and circumstances

that would have to be taken into account. Regardless of the level at which triggers or tools of intervention are agreed, there must be additional layers of analysis to ensure that tools had the same outcome in different jurisdictions and that trigger mechanisms delivered a consistent diagnosis across borders.

- Certain choices of trigger factors will bring additional practical considerations, if not all Member States have the legal powers or constitutional right to apply certain mechanisms.
 - With respect to solvency triggers: For example not all Member States choose to apply greater than 8% capital ratios to banking groups, whereas other Member States use higher than 8% capital ratios as triggers for closer scrutiny and/or power of intervention.
 - A variation of solvency triggers is the leverage ratio: this can be used simply as a general supervisory rule or it can be used as a trigger for specific intervention. At present few jurisdictions apply it, so there would be a major regime shift to introduce it.
 - Triggers based on liquidity indicators would face two main, and not unrelated, issues: first there is no harmonised liquidity regime on which to base analysis or choose liquidity factors; secondly liquidity is the risk area which is most susceptible to behavioural adjustments and therefore potentially least able to be consistently relevant across jurisdictions.

Early intervention mechanisms. Early intervention procedures might include: requirements to inject capital; the addition/removal of senior management; requirements to address systems and control lapses; restriction of an individual business line within an otherwise orderly institution.

In considering greater coordination structures, the following issues will need to be considered.

- Whether intervention procedures can or should apply to one or all entities within the group.
- Whether a trigger mechanism can be acted upon with sufficient speed in more than one jurisdiction.
- Whether certain intervention mechanisms (eg restriction of business, segregation of assets or injections of capital) would give rise to claims against the authorities by existing stake holders. For example current EU and national corporate law and national insolvency regimes will accord shareholders and investors various rights some of which could potentially challenge the success of rescue or restructure packages. It is important to note that these concerns can apply within a single jurisdiction, on an intra-EU basis, or between the EU and third countries.
- Whether certain mechanisms could only be delivered at a national level (pending changes to EU legal framework), based on the incorporation of the local entity – for example segregation of assets.

(c) Crisis management

Crisis management tools overlap considerably with those used in early intervention mechanisms. If early intervention tools have failed then it is possible that there is risk of contagion beyond a single entity/group/market/jurisdiction and the magnitude of the tasks and need for coordination likewise intensifies. Tools that are typically considered in relation to crisis management can be categorised quite broadly and include:

- Liquidity and capital support – whether between group entities (cross border or cross sector):
- Liquidity and capital injection by governments as part of formal rescue plans
- Segregation of assets (ring fencing); transfer of assets; recapitalisation plans
- Intervention in management of the entity (or entities)
- Intervention in the business of the entity or group (restriction of parts of business activity); mediation of merger or break up of entity/group whether whole or partial and whether to private or state sector.
- Orderly wind-down - Insolvency/administration procedures
- Investor compensation or depositor protection schemes
- Direct intervention in markets (eg short-selling restrictions)

The range of crisis management tasks represents perhaps the most difficult area of assessment and as indicated above, shares some similarity with difficulties that can be faced in early intervention procedures, although broadly it is the case that crisis management will involve the active participation of a wider range of authorities (early intervention tending to be the realm of supervisory authorities). The most acute issue, however, is that of funding resource – whether it is possible to broker private sector solutions, or in cases where the scale of difficulty warrants public interest, how much the public purse can pay and what are the mechanisms for delivering such support.

Other issues arising can include:

- Whether there are obstacles preventing capital and liquidity flowing to where it is needed;
- Whether firms themselves want to be able to cut loose problem subsidiaries or branches;
- Whether national supervisors will be faced with balancing the needs of the national economy and national investors against the wider good of the international market or Single Market working smoothly;
- If structural solutions (sale of assets/divisions of an entity or insolvency or administration) have been needed then there is an interface with liquidation, winding up, and insolvency laws. Insolvency law is not fully harmonised in the EU and nor is there a strong cross sectoral dimension to EU law. There may therefore under EU and/or national law be a range of rights and claims of the previous shareholders, creditors or even management of an institution/group that is in difficulty and this may inhibit public authorities achieving their preferred outcome.

- These are all part of the many and complex aspects of what to do in a crisis, and who has to pay, and whether those who are forced to pay have been included in or cut out of the chain of decision making. However, it is inevitable that if greater consistency is achieved in this area (a) it needs to be achieved at EU level via a considerable legislative programme which will by no means be easy to deliver; and (b) not all parties will consider their rights and protections to be enhanced – there will be a re-distribution and this will of itself impede the ability to change the legislative framework. However, this is an area where the key issues lie in the legislative fabric as opposed to the structure of the authorities who must act on the basis of the legislation.

In terms of practical coordination, a different set of issues emerges. It is necessary to consider to what extent crisis management tasks can be planned for in advance. In the current crisis, urgent rescue action has been complemented by much liaison between governments and other public authorities, both within the EU and globally, to maintain coordination and ensure that divergences between national approaches do not give rise to imbalances that could make the position worse, or introduce competitive imbalances. The question arises whether, and if so how far, it is possible to plan coordination in advance, or to establish guidelines for national action, in a way that might limit these disadvantages while still enabling national authorities to take the necessary urgent action. A major factor in considering this issue is that each crisis is likely to be different from the last, and it will therefore be important to ensure that national authorities' ability to act in a responsive and adapted way in future is not limited by constraints which were designed with the current crisis in mind, but which may not be relevant, or may exacerbate risk, in the future. Nonetheless, it is clearly agreed that any pre planning ought to ensure that all relevant authorities have a high minimum level of working knowledge of powers and mechanisms that can be activated, by whom, under what circumstances and who needs to be informed or give authority. This is one very useful area that crisis simulation activities have much to offer.

(ii) Financial Stability Cooperation

Having identified the tasks typically associated with Financial Stability, it is important to consider to what extent each set of tasks is susceptible to or would benefit from greater structural coordination or delivery at a regional or global level as opposed to national level. Before any new mode of EU cooperation or structure were adopted it would be necessary to satisfy the basic criterion that EU arrangements would fit with and support global arrangements and would not impede or hinder such global arrangements.

As with supervisory structures there is a range of models available ranging from the more decentralised to the more formally, and centrally, structured. Broadly, the possible arrangements could be summarised as follows:

- (a) Financial Stability Groups – ie groups of relevant national and international bodies and authorities cooperating to deliver the financial stability tasks.

- (b) System of European Financial Stability – ie analogous to the European System of Central Banks for the EU coordination of tasks.
- (c) EU financial stability mechanism - EU level forum equivalent to the Financial Stability Forum which is composed of ministries of finance, supervisors and central banks, pooling knowledge and focusing on standards.
- (d) A separate Financial Stability Regulator– ie the establishment of a separate Financial Stability regulator that is distinct from other supervisory regulation (ie prudential or conduct of business regulation).

As for supervision, we need to find the best way to reconcile the national accountability of financial stability and crisis management actors with necessary international (EU and global) cooperation. We also need to find how EU cooperation can best contribute to global stability. It may be that the most appropriate arrangements may differ for different financial stability tasks, or that a mixture of structures may be appropriate.

There is an argument that, even though EU arrangements may be imperfect, it is important, in a context where global cooperation arrangements are necessarily informal, to ensure that during a global crisis the EU deploys effectively the larger pool of potential government support that can be provided by Member States collectively rather than individually, thereby providing a better safety net for EU firms in a crisis. That is why it is important to design effective means of reconciling the national basis of crisis response with effective communication and coordination between Member States. It does not necessarily follow that the best way of doing so is to introduce a layer of financial stability management at EU level in relation to all financial stability and crisis management activities: coordination between Member States (and indeed between national authorities worldwide) is one of a range of factors that national authorities need to take into account in a crisis.

As with the discussion on supervision issues, it is helpful to assess different possible models of delivery against common factors to identify whether certain structures might work better than others.

(a) Compatibility with the global dimension

Financial Stability Oversight: if macro economic and macro prudential standards of surveillance and analysis are to improve, then the global dimension is essential. Although local bodies would presumably still be required in one form or another, a global effort to support the work of the IMF and the FSF can be achieved through greater coordination at EU level and in principle any of the structural options available ought to be successful. A EU financial stability mechanism might, however, be the most successful in that it would share essential structural features with the global FSF.

Early Warning Mechanisms: The capacity to establish a standard template of tools and to agree on a standard definition of trigger events exists in the EU. It is unlikely that an EU view would simply be adopted globally, but providing that careful analysis had taken place to assess the major potential difficulties between the EU regime and other major regimes to which the big international groups will be also subjected,

then there is certainly no obstacle to greater EU coordination or consistency. As it is important to ensure that such mechanisms fit well with national law in Member States it is likely that, at least in the short to medium term, progress could only effectively be made through structures that were either nationally based in the Member States or were a strongly coordinated system of such national authorities (eg a European Financial Stability mechanism).

Crisis Management: As for early intervention mechanisms.

Cross sector: As for early intervention mechanisms.

(b) Accountability and Lender of Last Resort

Financial Stability Oversight: Lender of Last Resort (LOLR) is not affected by financial oversight. Accountability however would have to be addressed, whether or not any EU structure fed into (eg) the IMF or FSF.

Early Warning Mechanisms: Accountability would follow the same pattern as the supervisory arrangements that were determined upon. However, the question cannot be considered in isolation from that of LOLR as early intervention may well lead to crisis situations and the need for LOLR. Ultimately decisions could not be made on new structures for delivering early intervention other than stronger early warning and coordination without resolving LOLR issues.

Crisis Management: Arguably Crisis Management is a synonym for LOLR. As for Early Intervention, it would be impossible to amend powers and create new bodies to exercise those powers without determining the LOLR arrangements in the event that the crisis deteriorated to that extent. Even aside from LOLR, however, the range of techniques that form part of the crisis management arsenal face a number of challenges in individual Member States as noted in the preceding section. The EU legislative framework can ameliorate this, providing the analysis and political will is there to address legal, cultural and potentially constitutional differences. Unless that work is carried out, there is little scope for formal new structures in the EU beyond intensive and effective cooperation and coordination mechanisms and ensuring that Member States are fully aware of the powers and indeed limitations faced by their own competent authorities and that of the authorities in other Member States. Again, an EU mechanism with accountability to the European Council (ECOFIN) could be a practical way to ensure coordination under high level political scrutiny.

Cross sector: As for crisis management, but with the additional dimension of another layer of legislative differences underpinning powers and authorities.

(c) Tools and Powers

Financial Stability Oversight: The essential tools of macro economic and macro prudential oversight are those of data gathering and analysis. Provided that information gateways have been effectively provided it is not obvious which the optimal structure in the EU might be for delivering this function.

Early Warning Mechanisms: At a regional level the capacity to establish a standard template of tools and to agree on a standard definition of trigger events exists in the EU. To the extent that there is a common EU view of appropriate tools and trigger events then the EU framework allows for Member States to put the necessary tools in place. But it would need to accommodate the caveats and the risks identified in the previous section.

Crisis Management: As for Early Warning Mechanisms – but recognising that the range of corporate, insolvency laws etc mean that greater consistency at the EU level is no easy task and one that needs to be addressed on its own terms, and cannot be delivered by a different structuring of EU authorities or bodies.

Cross sector: Tools and powers are not consistent across the different financial sectors within the EU, but clearly there is scope for this to be remedied if there is political will and the requisite better regulation processes and analysis. As with Early Intervention mechanisms and Crisis Management it is the interface with the legislative infrastructure rather than the structural institutional arrangement that determines whether there will be an effective understanding and response to the cross sectoral dimension.

(d) Standards

Financial Stability Oversight: Greater pooling of resource and cross fertilisation can be expected to enhance standards of oversight. It may be that strongly coordinated but not necessarily new bodies might have an optimal degree of balance between resource, local skill and increased exposure to peers in other EU and global bodies.

Early Warning Mechanisms: It is still important to consider the role of proximity and local expertise when early intervention mechanisms are being considered. An EU financial stability mechanism could be a useful repository of skills and ensure maximum coordination.

Crisis Management: Assuming once more that issues of LOLR and accountability had been resolved, it is still valid to consider whether it is more or less optimal for crisis management to be delivered nationally, close to the institutions affected, or more centrally. Would more centralised structures have greater potential to facilitate the spread of a crisis or failure, or strengthen authorities' ability to contain contagion? If intra-EU arrangements inhibited effective cooperation with non EU countries then they should not be pursued. Another important element to consider in this analysis is that of timing – ie in times of stress does the imperative of swift action mean that any ability to define and tailor precise arrangements in advance must be allowed flexibility? Does the significance of timing itself dictate the level at which crisis management must be conducted? This might argue for less remote and centralised bodies, but in favour of strongly coordinated structures like an EU financial stability mechanism on a permanent basis.

Cross sector: The issues are in common with those for Crisis Management and Early Warning Mechanisms.

(iii) Conclusion

Financial Stability issues, particularly pertaining to crisis management, involve a much broader range of activities and public authorities than direct financial services supervision. The greater breadth of activities and participants in financial stability issues reflects the significance of such issues in broad economic, fiscal, monetary, and foreign policy terms. The success of any cooperative arrangements or structures prior to any crisis, and indeed in the aftermath, will be demonstrated by the efficiency with which the additional authorities are apprised of essential information and the smoothness of continuing information flow that is maintained between supervisors.

The events of 2008 have demonstrated the complexity of the issues involved, and the rapidity with which the authorities and market actors must react to events. Whilst it is important to learn from these events to design the optimal arrangements for identifying warning signs, reacting appropriately, and responding if crisis prevention arrangements do not have the intended effect, it is also vital to bear in mind that the next crisis, if it occurs, will, almost inevitably, have different causes and raise different issues. The arrangements for international cooperation we design now will need to be adaptable enough to cope with a broad range of possible stresses, and also to avoid straitjacketing national authorities in ways that could exacerbate risks or prevent effective responses to them.

On the basis of the analysis presented above, we conclude that in terms of Financial stability issues the need for EU arrangements to mesh with the global dimension is vital. EU arrangements need to contribute to (and where appropriate lead) global cooperation, whilst remaining responsive to the pressures and limitations affecting authorities elsewhere in the world. They need to be adaptable: both to the next crisis, and to take account of the responsibilities and prerogatives of national authorities. And they need to be nimble in any crisis.

Based on the review of financial stability issues and concerns to be taken into account when deciding where functions should be delivered (ie at national, EU or global level) it is clear that there is no single model that is likely to be able to serve all purposes. Oversight and analytic mechanisms are the least fraught with legislative pitfalls but in other areas there are many potential national obstructions to the effective delivery of many inter-related financial stability tasks on a cross border basis even within the EU.

The EU has the ability to make a significant difference in this area through legislative means provided that the political will and commitment is present. Nonetheless, while there may be areas where intra-EU arrangements can enhance stability, inward-looking or over engineered arrangements for the EU alone risk exacerbating risk:

- by being based on an assessment of the position in the EU alone, whereas financial stability issues are by their nature likely to have global implications; or
- by being too rigid and formalised or remote, or
- by having too many layers of decision-making, to enable the authorities to respond quickly enough to contain immediate risks.

A number of issues, including effective enhancement of the legislative framework, and also of accountability dimensions such as Lender of Last Resort, would need to be addressed before there can be a more meaningful consideration of the best structures in which to organise the tasks and powers of the EU competent authorities.

At the present time, though, there is a priority for stronger mutual coordination and efficiency within the EU and between the EU and the global actors. Strong but flexible structures that support EU and global authorities in mutual cooperation, without cutting across or being blind to national restrictions and obligations, can support a stronger global consensus and ultimately the goal of strengthened financial stability at the global level.

EU Legislative issues

Any greater formalisation of arrangements for cooperation between Member States, whether in supervision or financial stability management, is likely to require EU law-making or standard setting. In this context, it is vital to consider the strengths and deficiencies of the EU process as it currently exists, and how it has been affected by recent events.

Many aspects of alignment of EU arrangements on supervision and financial stability management rely on generation of directives and regulations through the Level 1 and 2 process. In this process, the quality of output must continue to be the top priority, in which context effective regulation disciplines, including the importance of thorough consultation and impact analysis, must be retained. The aftermath of the financial crisis, combined with internal EU procedural constraints (in particular the imminent change of EC and EP elections) have led the Commission to propose legislation in several areas in a way that short cuts due process, and risks taking EU legislation out of line with what applies globally. It is important to adjust legislation to learn the lessons of the financial crisis, but it is important to do so in a measured and globally consistent way. There are serious concerns that some aspects of the current legislative programme (for example on securitisation and credit rating agencies) would harm the ability of EU markets and EU investors to benefit from the global economic upturn when it comes. There are important lessons here for the analysis of EU supervisory and financial stability arrangements.

Much EU legislation derives from global standard setters (e.g. Basel, IASB, IOSCO). In order to maintain its authority on the global stage, it is essential that the EU is fully involved developing global standards, and also that it adheres to the standards once they are agreed. That is why we are concerned at recent instances of EU departures from, or unilateral action in advance of, global standard-setting, for example in relation to securitisation retention, credit rating agencies, and fair value accounting. The EU is right to seek to take a leading role in global standard setting, but it needs to do so within, not outside, global structures. There are enormous risks in running ahead of global consensus, which are exacerbated by failings in due process and consultative process. The constraints that would be imposed by certain aspects of these recent proposals risk creating instability, both because they would make the EU less attractive to third country issuers and investors, and because they risk creating a regime in the EU that non EU countries (and global standard setters) will not be willing to follow or, in some circumstances (e.g. CRAs), may react to by imposing barriers to global cooperation and international trade. This is a message that we deliver to non-EU bodies also as the same risks exist in either direction.

Any adjustments to EU arrangements would also need to take account of the effect of the role of Level 3 committees in building trust and understanding between national supervisors, and fostering converged application of rules and identifying scope for further convergence of rules themselves. In this respect experience of Level 3 committees' ability to bring about converged application of rules where appropriate has been positive. Necessary enhancements as identified by ECOFIN are under way. It is vital that these improvements are preserved and continued.