International Conference
The Role of the Financial Sector in Promoting Economic Growth in Asia

The European Financial Regulation and Supervision

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Context

The financial crisis has shown the need for enhanced financial regulation.

Financial stability

"…a condition in which the financial system – comprising of financial intermediaries, markets, and market infrastructures – is capable of withstanding shocks and unraveling of financial imbalances…"

ECB Financial Stability Review, December 2009

Why a new financial stability framework was needed in the EU

- Market discipline was not sufficient
- Self-regulation by itself did not work
- Risk management techniques did not take into account endogenous behaviors of actors
- Compensation structures promoted short-term orientation
- Prudential regulation was not enough to achieve financial stability
- Attaining consumer prices stability did not ensure financial stability
- Fiscal policy became a big player of any strategies aimed to assure financial stability

Why a new financial stability framework was needed in the EU

- There was a lack of adequate macro-prudential supervision
- There was the absence of a truly harmonized set of rules in the EU and failure of supervision on a cross – border basis

The New Financial Stability Framework

- The new Framework needs to break with the leverage-led growth to prevent excessively loose macroeconomic policies from being source of financial instability
- Macroeconomic policies should be less prone:
  - To avoid any recession
  - To smooth business cycle
  - To rely on over-optimistic assumptions about potential output growth
  - To reject the need to act against the build-up of financial excesses

Contribution of the monetary policy dimension to the framework

- The stability of consumer prices is not sufficient to ensure macroeconomic stability
- Monetary policy should take better account of asset prices and credit booms

Contribution of the fiscal policy dimension to the framework

- Fiscal policy has become a shock absorber
- Fiscal policy should not be a source of shocks
- One-off taxes and levies on the financial sector

Contribution of the prudential policy dimension to the framework

- Microprudential framework: enhanced Basel II
- Macroprudential overlay

Failure of Microprudential Regulation

- Limits of regulation: the shadow banking system, outside the perimeter of regulation, generated large write-downs that threatened the solvency of systemically important financial institutions. The build-up of this systemic risk was not detected by supervisors
- Regulation was not enforced across countries with the same rigor

The new approach

The new approach: macro and micro supervisions

• **Macro prudential analysis** focuses on the financial system as a whole and devotes particular attention to the costs of the financial instability to the real economy.

• **Micro prudential analysis** focuses on financial institutions individually, including their liquidity, capital strength and risk management.

The two pillars of supervision

ESRB - European Systemic Risk Board

An independent body, without legal personality responsible for macro-prudential oversight across the EU financial system.

ESFS - European System of Financial Supervisors

Three independent bodies, the **European Supervisory Authorities**, with legal personality responsible for micro – prudential supervision with national authority and cross border college of supervisors.

- **EBA - European Banking Authority (ex CEBS)**
- **EIOPA - European Insurance and Occupational Pensions Authority (ex CEIOPS)**
- **ESMA - European Securities and Market Autorithy (ex CESR)**

European Systemic Risk Board

- Develop a framework for macro-prudential analysis in Europe

- To enhance the effectiveness of early warning system by improving the interaction between micro and macro prudential analysis

- To translate risk assessment into action by the relevant authorities

Core output: the preparation of high quality risk warnings

European Supervisory Authorities
European Banking Agency

- Members: all the members countries of the EU
- Management Board:
- Joint Board of Appeal
- Banking Stakeholder group
- Joint Committee

European Supervisory Authorities
European Securities and Markets Agency

- responsible for market disclosures and of regulation and supervision of rating agencies

Have all of the fundamentals causes the financial crisis been appropriately addressed in the reforms that have been undertaken?
What are the areas that are requiring more attention?

- Compensations of Bankers
- Statistical approaches to the Probability of defaults used in the internal models
- Deleveraging process and effects on the banking industry

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- Monitoring financial positions of households, firms and government
- Monitoring asset prices
- Double check the feed-back of financial bail-out on fiscal stabilization policy

Are the structures, governance and trasparency of the FSB and the standard-setting bodies adequate in view of their important roles?

- The new international bodies in charge of financial stability:
- The G-20 should assure that member countries implement consistent policies at a global level
- The Financial Stability Board (24 members) plays a key role in coordinating the work of national authorities and standard setters to ensure international consistency

Are the structures, governance and trasparency of the FSB and the standard-setting bodies adequate in view of their important roles?

- Structures could be adequate, but:

"Effective, timely and consistent implementation of agreed policies and standards at national level is essential: first, to resolve collective action and coordination problems; second, to prevent harmful arbitrage, spillovers and regulatory competition; and third, to preserve the benefits of a level playing field across the global financial system." (Draghi, 2009)

How will it possible to implement the various reform measures across countries in a consistent manner?

- Financial Integration on the example of European Union could be a consistent approach to the problem, even if only an adequate enforcement and juridisdiction can make effective the regulation

How will it possible to implement the various reform measures across countries in a consistent manner?

- The principal objective is to avoid that countries, to protect their own banking system, try to compete relaxing regulation and supervision standard
- Governments should have clear that the bailout of deposits and the guarantee of counterparty risk of banks, that can favor moral hazard behavior, are very expensive for tax payers
- Following this approach, governments could try to implement unilateral actions to protect domestic depositors and national taxpayers insisting that domestic depositors’ funds are ring fenced and that government does not underwrite the wholesale market obligations of banks located within its borders

Some conclusions

- The new framework needs the contribution of microprudential, macroprudential, monetary and fiscal policy that need to be strongly coordinated at an international level
- International and Technical bodies are ready to implement the new framework.
- We do not know if national governments are ready to devolve national responsibilities to the international community