

POSITION PAPER



**ESBG Response to
Proposals on financial supervision made in the de
Larosière report and the Commission Communication
from 4 March 2009**

10 April 2009



The European Savings Banks Group (ESBG) welcomes the opportunity to give its views on the proposals on financial supervision made in the de Larosière report and the Commission's Communication of 4 March 2009.

1. General remarks

The ESBG would like to congratulate the Members of the High Level Group chaired by Jacques de Larosière for the high quality report produced, which now constitutes the backbone of ongoing discussions on the future of financial supervision.

In our view, the analysis of the causes of the crisis provided in the report (section 1) is accurate and therefore constitutes a good basis for assessing where changes could be made. Likewise, we fully agree that the indicated shortcomings of the current framework can be addressed only through an approach covering both regulatory and supervisory aspects.

In principle, the ESBG welcomes the pragmatic approach proposed in the de Larosière report and its endorsement by the European Commission. Detailed comments to the specific proposals will be displayed in the following paragraphs.

2. Consultation and timeframe

The supervisory framework is of crucial importance for the stability of the EU financial markets. Therefore, the ESBG highlights that it is essential that the review of the current framework be given enough time for allowing a thorough assessment of all possible alternatives. Furthermore, given that the significant changes to the EU framework currently under consideration will have a substantial impact on all players in the financial markets, it is necessary for all stakeholders to be duly consulted.

The ESBG considers that the time foreseen for the present consultation (one month), accompanying a very ambitious and far-reaching project, does not permit stakeholders to provide extensive feedback. Hence, it should be seen merely as a way for gathering general views about stakeholders' positioning towards the recommendations put forward in the de Larosière report. The ESBG accordingly urges the Commission to allow for an appropriate consultation interval for the forthcoming, more concrete proposals expected to be issued later this year.

Furthermore, the substantial reforms proposed to the supervisory framework should be implemented gradually and smoothly, in order to avoid that sudden changes cause disruptions and impinge on the efficacy of supervisory activities. Therefore, we welcome the approach taken in the de Larosière report, which calls for a step-by-step implementation of the proposed changes. However, in the ESBG's view, the proposed timeframe is too ambitious. Especially, we perceive as neither realistic nor adequate the declared intention of the Commission to have the new supervisory arrangements in place before the end of 2010.



3. Macro-prudential aspects

General remarks

The ESBG agrees with the High Level Group's observation that too little was done on the macro-prudential side and that there was no adequate overview of the general developments in all financial sectors and markets, and therefore not enough knowledge of common and correlated shocks. For this reason, the ESBG particularly welcomes the proposals to establish a body explicitly entrusted with the tasks of gathering information on all macro-prudential risks in the EU and of issuing risk warnings. These tasks should be defined in sufficiently clear terms, so that they can be supported by adequate competencies and powers.

Flow of information

An efficient information flow is particularly relevant for the good functioning of the proposed new macro-prudential body. Concerning the question of the access to information by the macro-prudential body, this should occur via the national competent authorities. In our view, this would guarantee a level playing field and, provided there is a good organisation, would be more effective and offer a better picture of the situation in the financial markets. By contrast, if the authorities would gather their information directly from the relevant institutions, the information received might be only partial, as well as biased. Furthermore, such direct access to information from institutions would likely result in establishing *de facto* a two-tier system, with some institutions being monitored directly by the new macro-prudential body. This would not be in the ESBG's view an acceptable way forward.

Translation of macro analysis into micro prudential supervision

The biggest challenge with the proposal to have a stronger focus on the macro-prudential aspects is to find a way to ensure that the macro-prudential analysis is translated into appropriate action at the level of micro-prudential supervision. To this end, a clear framework needs to be designed, capable of successfully transferring the macro-prudential information into action at the micro-prudential level. It is important that such information is incorporated in the decision-making of national supervisory authorities, which are ultimately the ones in charge of conducting the supervision of individual institutions.

In ESBG's view the link between the macro and micro-prudential levels is not very clearly described in the de Larosière report. Recommendation 17 provides merely for mandatory follow-up on the macro-prudential risk warnings and for action by the relevant competent authorities "where appropriate". For risks of a serious nature, the report further foresees reporting by the new body to the Economic and Financial Committee (EFC) which, working with the Commission, should implement a strategy to address those risks. We believe that the transmission belt between the new macro-prudential body and the national supervisors should be made more explicit. Also, the involvement of the EFC and the Commission should be better clarified, in consideration of the fact that they also ultimately will have to rely for implementation on national authorities.

Remarks on the ESRC

As regards the proposed new body, the European Systemic Risk Council (ESRC), the ESBG understands that, by its very purpose, the ESRC should be close to the ECB. However, clear accountability lines should be established, making it straightforward who bears the ultimate



responsibility for ESRC's actions and how it interacts with the European System of Central Banks, without putting at risk the independence of the ECB and national central banks. Given that the ESRC is intended to replace the current Banking Supervision Committee (BSC), a smooth transition should be insured.

As regards the composition of the ESRC, the ESBG has some doubts as regards the proposal to have the European Commission represented, especially as it is one of the institutions responsible for defining the follow-up strategy to the warnings issued by the ESRC. In our view the body conducting macro-prudential analysis should not be subject to any political pressure.

Against this background, we are of the opinion that there is a need for more clarity about the status of the ESRC, its relations with the ECB, other relevant EU and national authorities, as well as its composition.

4. Micro-prudential aspects

In principle, the ESBG agrees with the objective of enhancing micro-prudential supervision in the EU via the establishment of an integrated network of European financial supervisors. The ESBG very much welcomes the recognition by the de Larosière High Level Group of the central role of national supervisory authorities, which due to their better knowledge and proximity to the markets are the best placed to continue carrying out day-to-day supervision. As consistently argued by the ESBG, a decentralised solution accompanied by better coordination and cooperation is warranted for safeguarding the interests of both home and host supervisors and in view of respecting the proportionality and subsidiarity principles.

Furthermore, we also support the emphasis in the report on reliance on colleges of supervisors, as these bodies have and will continue to have an important role to play in the supervision of cross-border entities.

In line with the report, the ESBG does not believe that a two tier system of supervision with competencies for systemically relevant banks transferred to the ECB or a European Supervisory Authority would be an appropriate way forward. The level playing field can be ensured, in our view, only by submitting all market participants to the same framework, applied proportionately to the size, complexity, business strategy and riskiness of an institution. Differentiating conceptually between systemically relevant and other banks is, in the ESBG's view, counterproductive and undesirable.

As regards the establishment of a European System of Financial Supervision (ESFS), the ESBG welcomes the step-by-step approach proposed in the Report of the High Level Group and would therefore invite the Commission to consider more cautiously the proposed merger of the different phases described in the Report. As consistently argued by the ESBG, an evolutionary approach is preferable, where changes to the existing framework are made progressively, in line with market developments and the degree of integration. Therefore, we welcome the recognition by the High Level Group of the importance of a preparatory stage when focus should be on convergence of supervisory and regulatory standards, upgrading of the quality of supervision and strengthening of current structures.

The ESBG believes that the competencies listed under Recommendation 21 could contribute to enhancing supervisory cooperation in the EU. As regards point iii (i.e. adoption of binding technical decisions applicable to individual financial institutions), the ESBG would suggest that such a



competence be given only in the specific and exceptional situation when no joint decision can be reached.

There are some concerns related to the practical creation of the ESFS as proposed by the de Larosière report, especially as regards the transformation of the Level 3 Committees into “Authorities”. The far-reaching supervisory competencies enumerated under Recommendation 21 involve large discretionary judgements on politically sensitive issues. They do not merely entail technical competencies, but involve delicate balancing between various interests. Therefore, the ESBG believes that it is particularly important that the so-much needed legitimacy of the new system is ensured and attribution of competencies thoroughly investigated in the light of EC law.

In line with the evolutionary model, the ESBG supports a sectoral approach capable of reflecting the specificity and complexity of the banking, insurance and respectively securities business. Eventually, at a later stage, it could be envisaged to integrate some or all of the supervisory activities in these sectors.

5. Crisis management

As already underlined in our January contribution to the work of the de Larosière Group, the ESBG believes that there is an inextricable link between prudential supervision and crisis management. Therefore, any change to the supervisory architecture should be accompanied by due consideration of crisis management related aspects. We very much welcome the recognition in the de Larosière report of the inter-relationship between crisis prevention, crisis management and crisis resolution tools and the explicit call for establishing a coherent and workable regulatory framework for crisis management in the EU.

As recognised also in the report, the success of crisis resolution of cross-border groups is conditional upon reaching an agreement on burden sharing. We welcome the proposal made in the report to develop more detailed criteria for burden sharing than those contained in the 2008 Memorandum of Understanding. We would support that the proposal to develop such criteria be taken up in parallel with the review of the supervisory framework, as the two issues are interdependent.

6. Regulation

As a preliminary remark, the ESBG would like to reiterate its strong belief that a distinction must be made between measures which require immediate action by regulators and policy makers (such as can be the case for instance for the stabilisation packages adopted by Members States) and regulatory measures adopted in order to avoid that situations such as the one we are faced with today repeat themselves. For that sort of issues, which do not have the same sense of urgency, a long term approach has to be taken.

Furthermore, in line with our contribution to the High Level Group, we would like to repeat our conviction that the right approach as regards amendments to the EU regulatory framework is one that builds on the existing set of rules, as opposed to one which would propose a complete overhaul of the rules in place. Concretely, this means that in our view, the Basel II international framework should continue to be the cornerstone of European banking legislation.



In this context, it should be reminded that the Basel II framework is relatively new, that its full effects have therefore not yet come to sight and that its implementation is still ongoing. Despite limited experience with it, first results are valued positively by our Members. ESBG is generally supportive of the Basel II approach, which is considered to have contributed to improving risk management and definitely constitutes a welcome progress with respect to Basel I. Also, they consider that the Basel II framework as such cannot be blamed for the crisis, as it only gradually and recently came into effect and was running in parallel with Basel I. Furthermore, Basel II has still large unexplored resources such as Pillar 2 that, once consistently applied, has the potential of preventing much of the risk-taking that contributed to the current crisis.

Yet, Basel II is not perfect and preliminary lessons drawn from the crisis point to some of its shortcomings, such as securitisation-related aspects. In light of the crisis, Basel II would need a fair assessment in order to establish whether and to what extent it eventually contributed to the crisis. However, questioning it altogether would be counterproductive.

We would like to warn once more against the temptation of adopting regulatory changes speedily, without giving sufficient attention to all their consequences, especially for the smaller entities, which have demonstrated resistance to the recent market events and have not been at the cause of to the current crisis. This leads us to draw the following conclusions:

- The principle of proportionality should be given due consideration when devising regulatory changes; we are concerned that this has not always been the case, notably in recent consultation papers (for more detail, see for instance the ESBG response to the Basel Committee's consultation paper on stress testing¹).
- Any regulatory change should be considered in line with the Better Regulation approach. This should be done on the basis of proper knowledge acquired through stocktaking exercises, broad consultation processes, cost-benefit analysis and impact assessments.

Having in mind the significant number of bodies working on possible regulatory changes (e.g. Basel Committee, FSF, IOSCO, European Commission) and the wide range of areas in which changes are envisaged, the ESBG is especially concerned about the risk of a lack of coherence between the envisaged measures, which could lead to a situation where new provisions would contradict or indeed 'cancel' each other. In other words, the cumulative impact of all initiatives should be looked at with particular attention, as an excessive additional regulatory burden could result in creating uncertainty in the banking community and thus prolonging the current situation. This reinforces us in our belief that all efforts should be made to stick to a solid and sound regulatory process.

In our opinion, areas which require further investigation are: rules on the trading book, convergence on Pillar 2, liquidity risk management, and finally measures to ensure the right approach between accounting rules and prudential standards. We also support the view that all market participants in the financial markets should be subject to appropriate regulation.

We would like to comment with some more detail on issues which have been given particular attention in the recent discussions: excessive procyclicality and excessive leverage in the financial system.

Procyclicality

¹ ESBG Response to Basel Committee's public consultation on Principles for Sound Stress Testing Practices and Supervision, March 2009



We support the recent statement by the Financial Stability Forum that we should ‘address procyclicality in the financial system’², as it is undeniable that some aspects of the financial system have led to undesirable procyclical effects. At the same time, it is important to have in mind that not all aspects of the financial system which are *cyclical* are necessarily *procyclical*, to the extent that they should be subject to some type of fixing. An in-depth analysis of the building blocks of the financial system and of their interaction is necessary to avoid taking wrong approaches.

The issues which should be looked at more closely are in our view: the use of models based on Value-at-Risk, mark-to-market approaches especially in irrational and not operational markets and over-reliance on credit ratings (especially as regards securitisation positions).

Leverage ratio

Attention has been increasingly devoted at international level to the introduction of a ‘leverage ratio’, as a response to the perception of excessive leverage in the financial sector in recent years. The ESBG is in principle not opposed to the introduction of measures aiming at limiting leverage in the markets, provided this is done in a way which truly contributes to the creation of a safer and sounder regulatory environment. The mere introduction of a supplementary ‘leverage ratio’, ignoring existing risk-based measures provided in the Basel II framework would in our view certainly not meet this objective.

The ESBG looks forward to contributing to debates which would aim at identifying the appropriate way to achieve the objective of avoiding excessive leverage in the financial system.

² Financial Stability Forum Issues Recommendations and Principles to Strengthen Financial Systems, 2 April 2009.



About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



European Savings Banks Group - aisbl

Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99

Info@savings-banks.eu ■ www.esbg.eu

Published by ESBG. April 2009