



Financial Market Supervision: European Perspectives

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Summary

The global financial crisis has sparked a debate over the cause and impact of the crisis. Academics and policymakers are searching for changes in the financial system that can correct any perceived weaknesses in the structure of regulation, the content of regulations, and the coverage of financial instruments and activities. Since the onset of the crisis, numerous proposals have been advanced to reform or amend the current financial system to help restore economic growth. In the United States, the Obama Administration has proposed a plan to overhaul supervision of the U.S. financial services sector. Senator Collins introduced S. 664, the Financial System Stabilization and Reform Act of 2009, with a companion measure, H.R. 1754, that was introduced by Representative Castle in the House of Representatives. The measures would create a Financial Stability Council and grant the Federal Reserve the authority to examine the soundness and safety of the financial system posed by bank holding companies. On March 16, 2010, Senator Dodd unveiled a proposal to reform financial markets that would include a Consumer Financial Protection Bureau within the Federal Reserve; a Financial Stability Oversight Council; new authority to liquidate banks; new regulations for credit rating agencies; new limits on banks' trading activities; and renovation of some federal banking legislation. Other measures include: S. 1682 (Senator Cantwell), the Derivatives Market Manipulation Prevention Act of 2009; S. 1803 (Senator Merkley), the Federal Reserve Accountability Act of 2009; S. 2756 (Senator Warner) the Financial Services Systemic Risk Oversight Council Act of 2009; H.R. 3795 (Representative Frank), the Over-the-Counter Derivatives Markets Acts of 2009; H.R. 3968 (Representative Ellison), to amend the Bank Holding Company Act; and H.R. 3996 (Frank), to improve financial stability. The crisis has underscored the fact that national and international financial markets have become highly integrated, and problems in one market can trigger contagion that can spread both among countries and into economic sectors to affect businesses, employment, and household well being. Increasingly, however, coordination among European capitals and between Europe and the United States has proven to be elusive.

Similarly, governments in Europe are considering what, if any, changes they should make to their national financial systems. Along with the United States and other countries, European countries also are considering changes to the international systems of financial supervision and regulation in order to ensure prosperity through the smooth operation of domestic and international financial systems. This process may include reconsidering the roles and responsibility of the central banks in the post-financial crisis era. Various organizations and groups are advancing a large number of recommendations and prescriptions. Some goals for any such adjustments may include providing an institutional structure for oversight and regulation that is robust, comprehensive, flexible, and politically feasible while providing appropriate incentive structures to preclude excessive risk-taking. Of course, there are no guarantees that amending the current system or employing a different regulatory and supervisory structure will preclude a repeat of the most recent financial crisis given that financial markets and institutions are continually growing, innovating, and responding to government- and market-imposed constraints.

This report addresses the European perspectives on a number of proposals that are being advanced for financial oversight and regulation in Europe. The European experience may be instructive because financial markets in Europe are well developed, European firms often are competitors of U.S. firms, and European governments have faced severe problems of integration and consistency across the various financial structures that exist in Europe.

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Overview

The global financial crisis has resulted in huge losses in wealth, jobs, and economic activity. In some cases, it has led to public demonstrations and to changes in national governments. Academics and policymakers generally agree that the financial system can benefit from additional supervision or regulation that addresses issues of systemic risk. Such efforts, however, likely will require hard, and possibly politically unpopular, decisions concerning the supervision and regulation of domestic financial markets and new layers of international coordination that could challenge entrenched national interests. Furthermore, there are no metrics for gauging whether such measures are a prescription for curing the current crisis or are a policy framework for preventing the next crisis, since financial markets are constantly innovating and responding to regulation and oversight. In addition, there are no models of market oversight or supervision that have proven to be clearly superior. In the absence of such a model, policymakers face a blizzard of recommendations, but few assurances that changes to domestic and international financial frameworks, most likely achieved with considerable institutional and political resistance, will preclude another crisis.

Currently, national governments are using a number of approaches to supervise financial markets. While the current situation is quite fluid, there seems to be some movement in national supervisory frameworks toward an integrated approach, as used in Great Britain and Germany. Regardless of which structural form is employed, regulating financial activities at the national level is complicated by the nature of modern financial markets that have become highly complex and interdependent. While regulation is set largely in a national context, financial institutions are international in their activities. Without consistent regulatory standards across national boundaries, banks, insurers, and securities companies can move their activities to jurisdictions with looser standards. National governments, however, generally are loathe to cede sovereignty to any supra-national institution, and efforts to reshape national financial authorities often face stiff opposition from entrenched interest groups.

Furthermore, national financial markets are not clones of one another, but reflect differences in the way they have been organized and philosophical differences over the way they are regulated and supervised. Indeed, national financial markets are custom-made structures that reflect differences in national experiences, government institutions, laws, and national customs. One thing the crisis has demonstrated, though, is that despite these differences, financial markets have become highly integrated. As a result, it has become increasingly more difficult, as evidenced by the current financial crisis, to contain financial problems in one market from affecting markets in seemingly unrelated areas.

The European Union has taken a number of steps to improve financial supervision among its members, including: strengthening the roles of advisory Committees in the areas of securities, banking, and insurance regulators; adopting regulations on credit rating agencies; providing funding in support of international accounting standards; and considering a measure to register hedge funds. The EU also adopted a proposal to have a European Systemic Risk Council and a European System of Financial Supervisors that will serve as advisors to EC members in providing advice in both macro and micro prudential supervision. The United States has chosen to take a different approach that could potentially strengthen the role of the Federal Reserve and create a new consumer watchdog agency, among other proposals.

At the G-20 summit in Pittsburgh in September 2009, the participants agreed to coordinate their actions on a number of financial reform issues. As the financial crisis has eased, however, such coordination has proved to be more elusive. EU banks have been slower than U.S. banks in meeting higher capital standards and less forthcoming in detailing their financial condition. The U.S., Britain, and continental European regulators also have forged different policies regarding the issue of executive compensation.¹ EU finance ministers also disagree over strict new regulations that would have imposed restrictions on American hedge funds operating in Europe. U.S. Treasury Secretary Geithner has called the new rules protectionist. The measure would have barred foreign hedge funds from operating in Europe unless standards similar to those that are enforced in Europe were enforced in the home countries. The British, in particular, have opposed the rules that are favored by the French and the Germans, in part because nearly 80% of European hedge funds operate out of Britain and are a major source of income.²

The European Union

The European Union (EU) is a political and economic union of 27 member states, formally established in 1993 by the Treaty of Maastricht out of existing structures that had evolved in steps since the 1950s. The EU has worked to develop a single economic market through a standardized system of laws which apply across all member states and which provide the freedom of movement of people, goods, services and capital. This process of economic integration is complicated by a dual system that gives the members of the EU significant independence within the EU and broad discretion to interpret and implement EU directives. EU economic integration is compounded further by sixteen member states, collectively known as the Eurozone³, which have adopted the euro as a common currency and operate as a bloc within the EU. Major institutions and bodies of the EU include the European Commission, the European Parliament, the Council of the European Union, the European Council, the European Court of Justice, and the European Central Bank (ECB). Through various Directives, the EU has moved to increase financial integration within the Union to make the monetary union represented by the Eurozone operate more efficiently.

Within the EU, the European Commission operates as the executive branch and is responsible for proposing legislation, implementing decisions, upholding the Union's treaties, and the general day-to-day running of the Union. The Commission operates as a cabinet government, with one Commissioner from each member. One of the 27 is the Commission President (currently José Manuel Barroso) appointed by the European Council, with the approval of the European Parliament, for a term of five years. Relative to the financial sector, the EU process provides for each member to have its own institutional and legal framework, which complicates efforts to coordinate financial policies. The Economic and Financial Affairs Council (ECOFIN) is one of the oldest bodies within the European Council. ECOFIN is responsible for economic policy coordination, economic surveillance, monitoring budget policy and preparing the EU's budget.

There are three main procedures the EU uses to enact legislation. These procedures are co-decision, assent, and consultation. The co-decision procedure, also known as the Article 251

¹ Schneider, Howard, U.S. Europe at Odds Over Financial Reform, *The Washington Post*, March 13, 2010, p. A1.

² Faiola, Anthony, E.U. Finance Officials at Impasse on Global Reform, *The Washington Post*, March 17, 2010, p. A16.

³ Members of the euro area are Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

procedure (Article 251 of the Treaty of Rome), is the main legislative process the EU employs to adopt directives and regulations. The Council and the European Parliament jointly adopt legislation based on a proposal by the European Commission. Both Parliament and the Council are required to agree on an identical bill before the measure can be adopted. In general terms, Parliament is considered to have adopted a measure if it fails to reject the proposed measure within three months after it has been adopted by the Council. Under the assent procedure, the Council can adopt a measure proposed by the Commission if it receives the assent of Parliament. Under the consultation procedure, the Council, acting unanimously or as a qualified majority, can adopt legislation developed by the Commission after it has consulted with Parliament.

Since the start of the financial crisis, the European Union has taken a number of steps to improve supervision of financial markets. These actions include:

- Strengthened the Committee of European Securities Regulators. The Committee is an advisory body without any regulatory authority within the European Commission. The Directive of January 23, 2009, strengthened the Committee's authority to mediate and coordinate securities regulations between EU members.
- Strengthened the Committee of European Banking Supervisors. The Committee is an advisory body without any regulatory authority that coordinates banking supervision. The EU Directive of January 23, 2009, broadened the role of the Committee to include supervision of financial conglomerates.
- Strengthened the Committee of European Insurance and Occupational Pensions Supervisors. The Committee is an advisory body without any regulatory authority within the European Commission in the areas of insurance, reinsurance, and occupational pensions fields. The January 23, 2009, Directive authorizes the Committee to coordinate policies among EU members and between the EU and national governments and other bodies.
- The European Parliament and the European Council approved on April 23, 2009 new regulations on credit rating agencies that are expected to improve the quality and transparency of the ratings agencies.
- Approved direct funding by the European Union to the International Accounting Standards Committee Foundation, the European Financial Reporting Advisory Group, and the Public Interest Oversight Body.
- The European Commission proposed a set of measures to register hedge fund managers and managers of alternative investment funds and measures to regulate executive compensation.
- Adopted measures to create a new European Systemic Risk Board (ESRB) and a European System of Financial Supervisors. The European Central Bank has been entrusted with providing analytical, statistical, administrative, and logistical support to the ESRB.

The euro area countries initially sketched out a broad response to the financial crisis. Since then, their response to bank foreclosures and to subsequent issues has been characterized by some as somewhat disjointed. The financial crisis and economic downturn have exposed deep fissures within the EU and even within the euro area countries over the policy course to follow. As a first response to the financial crisis, EU governments and their central banks focused policy initiatives on reassuring credit markets that there was an availability of credit and liquidity, by reducing

interest rates, and by providing foreign currency, primarily dollars, through currency arrangements. In addition to continuing efforts to restore the financial markets, EU members also face a worsening economic climate that has required actions by individual central banks, international organizations, and coordinated actions by EU members and other governments.

Financial Crisis

As the loss of real and financial wealth worsened, EU governments worked both independently and in tandem to protect financial institutions and to sustain economic growth. The actions EU leaders take are important to the United States, because EU members comprise some of the largest financial centers in the world, their financial markets are well developed, and European financial firms are often competitors to those in the United States. The economic and financial crises, however, have exposed deep philosophical differences among EU members over the most effective policy course to pursue to address the financial crisis and the economic downturn and problems of integration and consistency across countries. In part, these differences reflect the dual nature of the EU system, which gives great deference to the individual members of the EU in interpreting and implementing EU Directives. Unlike the United States, where the Federal government can implement policies that are applied systematically across all 50 States, EU-wide actions reflect compromise among 27 national authorities.⁴

The financial crisis has made EU members especially concerned about the size and structure of financial systems and they are pursuing changes to the international financial system. Financial systems have become large, complex, interconnected structures that have grown so large that some observers question whether the current financial system is compatible with maintaining financial stability. They also raise concerns about the ability of national governments to restrain the impact of financial firms on public resources should major financial firms face periods of serious distress. The United Kingdom and the United States, for instance, are the two largest international banking centers in the world. As such, they operate as major conduits, or as intermediaries, through which capital flows from countries with excess capital to those countries in need of capital. Banking centers in the United Kingdom, Switzerland, and elsewhere are notable because they are large compared to their respective national gross domestic product (GDP) and large compared to the relative size of banking centers in the United States. Bank assets in Switzerland, for instance, are nearly nine times the size of the country's GDP, while such assets are over four times GDP in the United Kingdom. In Spain, Germany, France, and Ireland, bank assets are at least double GDP, while such assets run less than 60% of GDP in the United States. In an effort to address the prospect that large banks or financial firms may become insolvent or fail and, thereby, cause a major disruption to the financial system, the British Parliament in February 2009 passed the Banking Act of 2009. The act makes permanent a set of procedures the U.K. Government had developed to deal with troubled banks before they become insolvent or collapse. Such procedures are being considered by other EU governments and others as they amend their respective supervisory frameworks.

Within the EU system, the greatest share of responsibility for regulating and supervising financial markets rest with the national governments. National authorities implement EU Directives in

⁴ Members of the European Union are: Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Republic of Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Sweden, and the United Kingdom.

ways they determine are consistent with their own national objectives and national interests, not necessarily to benefit the EU as a whole. As a consequence of this focus at the national level, there is some potential for nations to act in their own interests at the expense of other EU members, especially during periods of financial and economic distress. The financial crisis also has aggravated conflicts between broad EU-wide goals and the more focused national objectives of the individual EU members. For instance, as financial markets faced serious shortages of liquidity, EU members were pressed to support a broad set of measures to increase the guarantees on bank accounts for depositors in response to actions by Ireland, Greece, and Germany. In addition, some EU members have been considering a set of procedures to deal with the bad loans of banks within their jurisdictions, which has pushed the EU as a whole to follow suit and consider the best approach to deal with the toxic loans of EU banks. These differences may well become more pronounced as multilateral discussions shift from addressing the general goal of containing the financial crisis to the more contentious issues of specific market reforms, regulations, and supervision.

The globalization of financial markets raises the stakes for a coordinated response within the EU and between the EU and the United States. In various ways, globalized financial markets challenge the effectiveness of the current framework of financial market supervision and coordination that is based on national interests. Significant differences remain among EU members and between EU members and the United States over the best approach to follow to supervise financial markets. Some EU members favor a strong central authority that can monitor financial markets, while others favor strong national authorities with a weaker role for an international body.

The EU approach is also complicated by the requirement that new policies must mesh with the carefully crafted and highly negotiated Directives that already exist within the EU framework. These Directives act as guiding principles for EU members, and include the Stability and Growth Pact⁵, the Lisbon Principles,⁶ and the Financial Services Action Plan.⁷ Arguably, these agreements have helped stabilize economic conditions in Europe by bringing down the overall rate of price inflation and by reducing government budget deficits. In addition to these Directives, the EU members have adopted a series of measures that deal directly with an EU-wide effort to coordinate financial policies across all the EU members.

⁵ The Stability and Growth Pact (SGP) is an agreement by European Union members to conduct their fiscal policy in a manner that facilitates and maintains the Economic and Monetary Union of the European Union. The Pact was adopted in 1997 and is based on Articles 99 and 104 of the European Community Treaty, or the Maastricht Treaty, and related decisions. It consists of monitoring the fiscal policies of the members by the European Commission and the Council so that fiscal discipline is maintained and enforced in the Economic and Monetary Union (EMU). The actual criteria that members states must respect are: (1) an annual budget deficit no higher than 3% of GDP, and (2) a national debt lower than 60% of GDP, or approaching that value.

⁶ The Lisbon Strategy for Growth and Jobs is a plan adopted by EU members to improve economic growth and employment among the EU members by becoming the most competitive knowledge based economy in the world by 2010. The comprehensive strategy includes adopting sustainable macroeconomic policies, business friendly regulatory and tax policies and benefits, improved education and training, and greater investment in energy efficient and environmentally friendly technology. Two major goals include total public and private investment of 3% of Europe's GDP in research and employment by 2010, and an employment rate of 70% by the same date. A comprehensive report on the Lisbon Strategy is available at: http://ec.europa.eu/growthandjobs/pdf/kok_report_en.pdf.

⁷ The Financial Services Action Plan replaced the Investment Services Directive and contains a set of measures that are intended to remove the remaining formal barriers in the financial services market among EU members and to provide a legal and regulatory environment that supports the integration of the EU financial markets. *The EU Financial Services Action Plan: A Guide*, HM Treasury, the Financial Services authority, and the Bank of England, July 31, 2003.

As part of the overall EU effort to achieve financial and economic integration, the EU members have adopted such Directives as the Directive on Financial Services and the Financial Services Action Plan (FSAP). The integration of the financial services sector across borders, however, has been uneven, with integration progressing faster in the money, bond, and equity markets, and slower in the banking sector where much of the focus on international cooperation is being directed. According to the European Central Bank,⁸ retail banking services remain segmented along national lines as a result of differences in national tax laws, costs of national registration and compliance, and cultural preferences. Nevertheless, cross-border mergers and acquisitions within Europe have played an important role in internationalizing banking groups, which has led to significant cross-border banking activity. Integration within the banking sector in Europe also has increased since the euro-area countries adopted the euro as their single currency.

Other Major EU Financial Directives

Investment Services Directive

The EU has adopted a number of directives that provide a basic framework for EU members to coordinate financial regulation across the EU and to integrate financial sectors. One such directive is the Investment Services Directive (ISD) that entered into force on January 1, 1996. The ISD provided general principles for national securities regulations, with the goal of providing mutual recognition of regulations across the EU.⁹ The ISD created a “European Passport” that provided for a cross-border right of establishment for non-bank investment firms and the freedom to provide services across borders for investment firms to carry out a wide range of investment business. Under the passport, firms were authorized and supervised by domestic authorities, but could still provide specified investment services in other EU countries. Such cross border services included: collecting and executing buy and sell orders on an agency basis; dealing, managing and underwriting portfolios; and such additional services as providing investment advice, advising on mergers and acquisitions, safekeeping and administration of securities, and foreign exchange transactions.

The European “passport” provision required member states to dismantle restrictive legislation that prevented cross-border branching and freedom of services. Nevertheless, EU members retained the responsibility for determining their own domestic laws and regulations concerning such issues as fitness, authorization, capital requirements, and protection of client assets. EU members could also impose rules and regulations on investment firms using the European passport as long as the rules and regulations were, “in the interest of the general good,” and applied to the business activities that the firms carried out in their state. The ISD opened up stock exchange membership in all member states to all types of investment firms, whether bank or non-bank entities. Another objective of the ISD was to eliminate the so-called concentration rule in order to allow member states that lacked their own securities trading floor to access electronic terminals with investment firms and banks in other member states, thereby allowing them to be members of the markets on a remote electronic basis.

⁸ *EU Banking Structures*, European Central Bank, October 2008.

⁹ Davies, Ryan J., *MiFID and a Changing Competitive Landscape*, July 2008, p. 3; available at http://faculty.babson.edu/rdavies/MiFID_July2008_Davies15.pdf.

Financial Services Action Plan

In 1999, the EU replaced the Investment Services Directive with the Financial Services Action Plan (FSAP). The Plan consists of a set of measures that are intended to remove the remaining formal barriers in financial markets among EU members and to provide a legal and regulatory environment that supports the integration of EU financial markets.¹⁰ Similar to the ISD, the FSAP process supports a two pronged approach that combines EU directives with national laws. The EU directives provide for a general level of regulation concerning the provision of financial services across borders and the harmonization of national regulations governing cross-border activities. EU members, however, retain the right to regulate firms within their own borders, as long as those firms, whether foreign or domestic, are treated equally. The FSAP contains 42 articles, 38 of which were implemented, that are intended to meet 3 specific objectives: (1) a single wholesale market; (2) an open and secure retail market; and (3) state-of-the art rules and supervision. Wholesale measures relate to securities issuance and trading; securities settlement; accounts; and corporate restructuring. Retail measures relate to insurance; savings through pension funds and mutual funds; retail payments; electronic money; and money laundering.

Markets in Financial Instruments Directive

The cornerstone of the FSAP's achievement is the Markets in Financial Instruments Directive (MiFID), which became effective on November 1, 2007. The MiFID establishes a comprehensive, harmonized set of rules for Europe's securities markets so financial services firms can provide investment services in each of the EU member states. MiFID retained the principles of the EU "passport" and extended the list of services and financial instruments that are covered by the passport procedures, including investment advice. MiFID also removed the so-called concentration rule that required investment firms to route all stock transactions through established exchanges.

MiFID introduced the concept of 'maximum harmonization' which places more emphasis on home state supervision. This is a change from the prior EU financial service legislation which featured a "minimum harmonization and mutual recognition" concept. Minimum harmonization provides for a law or a regulation that sets a floor, or a minimum standard, that EU countries were expected to meet in developing legislation. Maximum harmonization provides for a maximum level of a law or a regulation that sets the maximum allowable standard that can be adopted in domestic laws or regulations. At times some EU members have been accused of adopting domestic measures that exceed the EU standard in a manner that acted as a protectionist barrier.

Some key elements of the MiFID are:

- Authorization, regulation and passporting. Firms covered by MiFID are authorized and regulated in their "home state." Once a firm is authorized, it can use the MiFID passport to provide services to customers in other EU member states. These services are regulated by the "home state" in which the firm is authorized.

¹⁰ *The EU Financial Services Action Plan: A Guide*, HM Treasury, the Financial Services Authority, and the Bank of England, July 31, 2003.

- Client categorization. MiFID requires firms to categorize clients as “eligible counter-parties,” professional clients, or retail clients, with increasing levels of protection.
- Client order handling. MiFID places requirements on information that needs to be captured when firms accept client orders in order to ensure that a firm is acting in a client’s best interests.
- Pre-trade transparency. MiFID requires the operators of various kinds of equity exchanges to make the best bid and offer prices available to potential buyers and sellers.
- Post-trade transparency. MiFID requires firms to publish the price, volume and time of all trades in listed shares, even if executed outside of a regulated market, unless certain requirements are met to allow for deferred publication.
- Best execution. MiFID will require that firms take all reasonable steps to obtain the best possible result in the execution of an order for a client. The best possible result is not limited to execution price but also includes cost, speed, likelihood of execution and likelihood of settlement and any other factors deemed relevant.
- Systematic Internalizer. A Systematic Internalizer is a firm that executes orders from its clients against its own book or against orders from other clients and are treated as mini-exchanges, which makes them subject to pre-trade and post-trade transparency requirements

Capital Requirements Directive

The Capital Requirements Directive, which became effective in January 2007, introduced a supervisory framework within the EU for investment management firms and banks. The purpose of the Directive is to move the EU towards complying with the Basel II¹¹ rules on capital measurement, adequacy, and related market disclosure disciplines. This Directive promotes a risk based capital management methodology through a “three pillar” structure that includes (1) new standards that set out the minimum capital requirements that firms will be required to meet for credit, market, and operational risk; (2) requirements that firms and supervisors must decide whether they are holding enough capital to address the risks realized under Pillar I and act accordingly; and (3) requirements that firms publish certain details about their risks, capital, and risk management. The Directive also requires firms to make provision for a charge against their capital for operational risks in order to identify, monitor, manage, and report on certain types of external events that may have a negative effect on their capital. The Directive applies not only to internationally active banks, which is the main focus of the Basel II approach, but it also applies to all credit institutions and investment firms irrespective of the size, scope of activities, or levels of sophistication. Under the Directive, firms are required to meet rules governing the minimum amounts of their own financial resources they must have in order to cover the risks to which they may be exposed.

¹¹ Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations concerning requirements for capital adequacy that banks must meet to guard against the types of financial and operational risks that banks face.

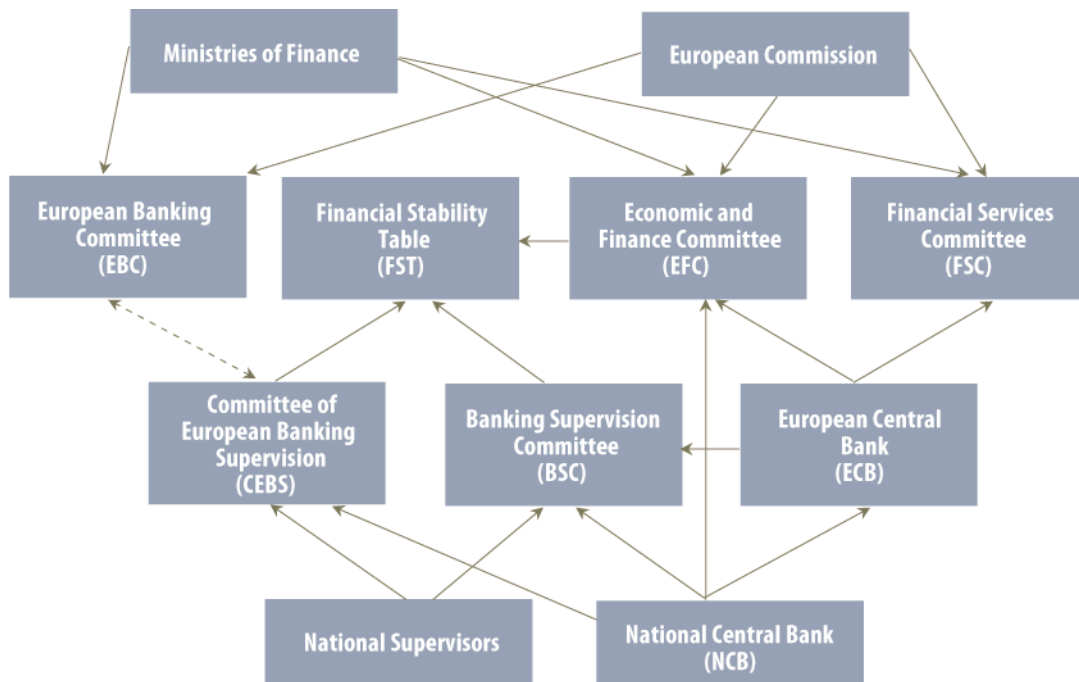
EU Financial Supervisory Authorities

Within the EU, there are a number of bodies that bring together the supervisors, finance ministers, and central bankers of the EU members, as indicated in **Figure 1**. These bodies are under the direction of the European Commission and the Ministries of Finance of the individual EU members, while they also are subject to the central banks and National Supervisors¹² of each EU member. Within the European Council, the Economic and Financial Affairs Council (ECOFIN) is one of the oldest bodies associated with the Council. ECOFIN is responsible for coordinating economic policy, performing economic surveillance, and for monitoring budget policy and preparing the EU's budget. The key bodies in the EU banking sector include the following:

- **European Banking Committee.** The committee consists of representatives of the ministries of finance of the EU members and advises the EU Commission on policy issues related to banking activities and on proposals in the banking area.
- **Committee of European Banking Supervision.** The committee is comprised of representatives of supervisory authorities and central banks and coordinates on regulatory and supervisory convergence.
- **European Central Bank.** The ECB's main role is financial stability and monitoring in cooperation with national central banks and supervisory agencies.
- **Banking Supervision Committee.** This committee brings together national central banks, banking supervisory authorities, and the ECB. It monitors and assesses developments in the euro area, analyses the impact of regulatory and supervisory requirements on financial system stability, and it promotes cooperation and exchange of information between central banks and supervisory authorities on issues of common interest.
- **Economic and Financial Committee.** The committee includes representatives of ministries of finance, the European Commission, the ECB, and central banks to promote high-level assessments of developments in financial markets.
- **Financial Stability Table.** This body meets twice a year to discuss financial stability issues.
- **Financial Services Committee.** This committee is composed of representatives of the ministries of finance and the European Commission and discusses and provides guidance on cross-sector strategic and policy issues.

¹² National Supervisors are one or more supervisory authorities that are authorized at the national level and are accountable to national mechanisms to issue regulations, grant licenses, conduct supervision, and to take enforcement action.

Figure 1. Key Bodies in the EU Banking Sector-Stability Framework



Source: OECD Economic Studies: Euro Area, Organization for Economic Cooperation and Development, 2009.

In addition to the committees and bodies indicated in **Figure 1**, there are other components to the EU financial structure. Some EU members have negotiated Memorandum of Understanding (MOU) agreements that commit the parties to a regular exchange of information and to consultation on enforcement of regulations. EU members also have developed “Colleges” of supervisors that represent each EU member in coordinating policies on financial activities that cross national borders, principally in such specific areas of financial services as insurance and banking. In addition, three financial services committees organized under the so-called Lamfalussy process¹³ promote financial sector integration in the banking, insurance, and securities sectors. These committees are designated as Level 3 committees since they operate at the third stage in a process designed to coordinate efforts among the EU members in order to build support to implement legislation.

Within the EU, the structure of financial market supervision varies markedly, as indicated in **Table 1**. Likewise, the objectives and mandates of the supervisory authorities, the central banks, the Ministries of Finance, and other organizations also vary by individual country, according to a

¹³ The Lamfalussy process, named after Alesandre Lamfalussy who chaired the EU advisory committee that created it, was adopted by the EU members in 1999 to accelerate the legislative process in the EU relative to financial services legislation in order to meet the implementation deadline of the financial Services Action Plan by 2005. The process is composed of four levels, each focusing on a specific stage in the implementation of legislation with the EU. Level I establishes the core values of a law and is the traditional EU decision making, in which decisions are adopted as Directives or Regulations proposed by the Commission and then approved under the co-decision procedure by the European Parliament and the EU Council. At the second level, sector-specific committees and regulators provide advice on developing the technical details of the principles that were adopted in Level I. At the third level, national regulators work on coordinating new regulations with other nations. The fourth level involves compliance and enforcement. This process is intended to promote consistent interpretation, convergence in national supervisory practices, and an improvement in the quality of legislation on financial services.

staff report prepared by the International Monetary Fund.¹⁴ Among the 27 members of the EU, a little more than half have a single supervisory authority overseeing the banking sector, while slightly less than half have a sectoral model, or a supervisory authority that focuses on a particular segment of the financial services industry. The central bank is involved in supervising the financial markets in every EU country, but it acts as a supervisory authority in only half of the members. In all of the EU members, the banking supervisory authority supervises banks and insurance providers and in all but one country, the supervisory authority also supervises securities firms. In slightly fewer countries, the banking supervisory authority also supervises the management of pension funds. Also, in nearly every EU country, the banking supervisory authority is responsible for maintaining stability in the financial system and for protecting the deposits and other interests of consumers. Fewer than half of the banking supervisory authorities are responsible for supervising the conduct of firms within the financial sector and only about one-third are responsible for maintaining or ensuring that there is competition in the market.

¹⁴ Hardy, Daniel, A “European Mandate” for Financial Sector Authorities in the EU, in *Euro Area Policies: Selected Issues*, the International Monetary Fund, IMF Country Report No. 08/263, August 2008.

Table I. European Union Financial Supervisory Structures

Country	Supervisory structure			Main tasks/areas of supervision of banking supervisory authority									
	Sectoral model	Model by objectives	Single authority	Central bank as supervisory authority	Central bank involvement	Banking supervision	Pension fund supervision	Insurance supervision	Securities supervision	Stability	Conduct of business	Consumer protection	Market competition
Austria			X	X	X	X	X	X	X	X	X	X	
Belgium			X		X	X	X	X	X		X	X	X
Bulgaria	X			X	X	X	X	X	X	X		X	
Czech Rep.			X	X	X	X	X	X	X	X	X		X
Cyprus	X			X	X	X	X	X	X	X		X	X
Denmark			X		X	X	X	X	X	X	X	X	
Estonia			X		X	X		X	X	X	X	X	
Finland	X				X	X		X	X	X	X	X	
France	X				X	X		X	X	X		X	
Germany			X	X	X	X		X	X	X	X	X	
Greece	X			X	X	X		X	X	X	X	X	
Hungary			X		X	X	X	X	X	X	X	X	X
Ireland			X		X	X		X	X	X		X	X
Italy	X			X	X	X	X	X	X	X	X	X	X
Latvia			X		X	X	X	X	X	X		X	
Lithuania	X			X	X	X		X	X	X		X	X
Luxembourg						X	X	X	X	X		X	
Malta			X		X	X		X	X		X	X	X
Netherlands		X		X	X	X	X	X	X	X	X	X	X
Poland			X		X	X	X	X	X	X			
Portugal	X	X		X	X	X	X	X	X	X		X	
Romania	X			X	X	X	X	X	X	X			

Country	Supervisory structure			Main tasks/areas of supervision of banking supervisory authority									
	Sectoral model	Model by objectives	Single authority	Central bank as supervisory authority	Central bank involvement	Banking supervision	Pension fund supervision	Insurance supervision	Securities supervision	Stability	Conduct of business	Consumer protection	Market competition
Slovakia			X	X	X	X	X	X	X	X	X	X	X
Slovenia	X			X	X	X	X	X	X	X		X	
Spain	X			X	X	X	X	X	X	X		X	
Sweden			X		X	X	X	X	X	X		X	
United Kingdom			X		X	X		X		X		X	

Source: Hardy, Daniel, A “European Mandate” for Financial Sector Authorities in the EU, in *Euro Area Policies: Selected Issues*, International Monetary Fund. IMF Country Report No. 08263, August 2008, p. 76.

The “European Framework for Action”

As an initial response to the financial crisis, the European Commission released on October 29, 2008, its “European Framework for Action” as a way to coordinate the actions of the 27 member states of the European Union.¹⁵ On November 16, 2008, the Commission announced a more detailed plan that brings together short-term goals to address the current economic downturn with the longer-term goals on growth and jobs that are integral to the Lisbon Strategy for Growth and Jobs that was adopted by the EU in 2000 and recast in 2005.¹⁶ The short-term plan focuses on a three-part approach to an overall EU recovery action plan/framework. The three parts to the EU framework are:

- **A new financial market architecture at the EU level.** The basis of this architecture involves implementing measures that EU members have announced as well as providing for: (1) continued support for the financial system from the European Central Bank and other central banks; (2) rapid and consistent implementation of the bank rescue plan that has been established by the member states; and (3) decisive measures that are designed to contain the crisis from spreading to all of the member states. As the financial system is stabilized, the next step is to restructure the banking sector and to return banks to the private sector. Proposals include: deposit guarantees and capital requirements; regulation and accounting standards; credit rating agencies; executive pay; capital market supervision; and risk management.
- **Dealing with the impact on the real economy.** The policy instruments that can be employed to address the expected rise in unemployment and decline in economic growth are in the hands of the member states. Nevertheless, the EU can assist by adding short-term actions to its structural reform agenda, while investing in the future through: (1) increasing investment in R&D innovation and education; (2) promoting flexicurity¹⁷ to protect and equip people rather than specific jobs; (3) freeing up businesses to build markets at home and internationally; and (4) enhancing competitiveness by promoting green technology, and overcoming energy security constraints and achieving environmental goals. In addition, the Commission will explore a wide range of ways in which EU members can increase their rate of economic growth.
- The impact of the financial crisis on the real economies of the EU members likely will require adjustments to the fiscal and monetary policies of the EU members. The Stability and Growth Pact¹⁸ of the EU members should serve as

¹⁵ *From Financial Crisis to Recovery: A European Framework for Action*, Communication From the Commission, European Commission, COM(2008) 706 final, October 29, 2008.

¹⁶ The Lisbon Strategy for Growth and Jobs is a plan adopted by EU members to improve economic growth and employment among the EU members by becoming the most competitive knowledge based economy in the world by 2010. The comprehensive strategy includes adopting sustainable macroeconomic policies, business friendly regulatory and tax policies and benefits, improved education and training, and greater investment in energy efficient and environmentally friendly technology. Two major goals include total public and private investment of 3% of Europe’s GDP in research and employment by 2010, and an employment rate of 70% by the same date. A comprehensive report on the Lisbon Strategy is available at: http://ec.europa.eu/growthandjobs/pdf/kok_report_en.pdf

¹⁷ The combination of labor market flexibility and security for workers.

¹⁸ The Stability and Growth Pact (SGP) is an agreement by European Union members to conduct their fiscal policy in a (continued...)

the blueprint for members facing higher than expected levels of fiscal or monetary stimulus so that such policies should be accompanied by structural reforms. Such reforms should aim to sustain domestic demand in the short-run, ease transitions within and into the labor market, and increase potential growth by directing investment into areas that will sustain employment and advance productivity. Reforms in the finance sector should focus on enhancing the competitive position of the European industry and finance the needs of small and medium-sized firms. The Commission will also attempt to counter an expected increase in unemployment by using funds provided under the European Social Fund¹⁹ to reintroduce unemployed workers back into the work force.

- **A global response to the financial crisis.** The financial crisis has demonstrated the growing interaction between the financial sector and the goods- and services-producing sectors of economies. As a result, the crisis has raised questions concerning global governance that are relative to the financial sector and to the need to maintain open trade markets. The EU used the November 15, 2008 multi-nation economic summit in Washington D.C. to promote a series of measures to reform the global financial architecture. The Commission argued that the measures should include: (1) strengthening international regulatory standards; (2) strengthening international coordination among financial supervisors; (3) strengthening measures to monitor and coordinate macroeconomic policies; and (4) developing the capacity to address financial crises at the national regional and multilateral levels. Also, a financial architecture should be constructed upon three key principles: (1) efficiency; (2) transparency and accountability; and (3) representation in any group should include key emerging economies.

The de Larosiere Report and the European Plan for Recovery

When the European Union released its “Framework for Action” in response to the immediate needs of the financial crisis, it was moving to address the long-term requirements of the financial system. As a key component of this approach, the EU commissioned a group within the EU to assess the weaknesses of the existing EU financial architecture. It also charged this group with developing proposals that could guide the EU in fashioning a system that would provide early warning of areas of financial weakness and chart a way forward in erecting a stronger financial system. As part of this way forward, the European Union issued two reports in the first quarter of 2009 that address the issue of supervision of financial markets. The first report,²⁰ issued on February 25, 2009, and commissioned by the European Union, was prepared by a High-Level Group on financial supervision headed by former IMF Managing Director and ex-Bank of France

(...continued)

manner that facilitates and maintains the Economic and Monetary Union of the European Union. The Pact was adopted in 1997 and is based on Articles 99 and 104 of the European Community Treaty, or the Maastricht Treaty, and related decisions. It consists of monitoring the fiscal policies of the members by the European Commission and the Council so that fiscal discipline is maintained and enforced in the European Monetary Union (EMU). The actual criteria that member states must respect are (1) an annual budget deficit no higher than 3% of GDP, and (2) a national debt lower than 60% of GDP or approaching that value.

¹⁹ The European Social Fund, created in 1957, is the EU’s main financial instrument for assisting members in implementing their own plans for investing in workers.

²⁰ *Report*, The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosiere, February 25, 2009.

Governor Jacques de Larosiere and, therefore, is known as the de Larosiere Report. The second report²¹ was published by the European Commission to chart the course ahead for the members of the EU to reform the international financial governance system.

The de Larosiere Report

The de Larosiere Report focused on four main issues: (1) causes of the financial crisis; (2) organizing the supervision of financial institutions and markets in the EU; (3) strengthening European cooperation on financial stability, oversight, early warning, and crisis mechanisms; and (4) organizing EU supervisors to cooperate globally. The report proposed 31 recommendations on regulation and supervision of financial markets. The recommendations are summarized in **Appendix**.

The report argued that the financial crisis was characterized by a systemic failure to correctly price the risk of financial instruments as a result of plentiful liquidity, low returns, and investors seeking higher yields. Together, these events led to a fundamental failure by financial firms to adequately assess the risks associated with their activities and it exposed a systemic failure on the part of regulators and financial supervisors. In this environment, long-standing practices that relied on the risk management capabilities of the financial institutions themselves and on the adequacy of credit ratings all proved to be inadequate. Too much attention was paid to each individual firm and too little attention was given to the impact of general developments on sectors or markets as a whole. According to the report, “These developments point to serious limitations in the existing supervisory framework globally, both in a national and cross-border context.”²² According to the report:

Regulators and supervisors focused on the micro-prudential supervision of individual financial institutions and not sufficiently on the macro-systemic risks of a contagion of correlated horizontal shocks. Strong international competition among financial centers also contributed to national regulators and supervisors being reluctant to take unilateral action.²³

As the financial crisis unfolded, the de Larosiere Report concluded, the regulatory response by the European Union and its members was weakened by, “an inadequate crisis management infrastructure in the EU.” Furthermore, the report emphasized that an inconsistent set of rules across the EU as a result of the closely guarded sovereignty of national financial regulators led to a wide diversity of national regulations reflecting local traditions, legislation, and practices. While micro-prudential supervision focused on limiting the distress of individual financial institutions in order to protect the depositors, it neglected the broader objective of macro-prudential supervision, which is aimed at limiting distress to the financial system as a whole in order to protect the economy from significant losses in real output. In order to remedy this obstacle, the report offered a two-level approach to reforming financial market supervision in the EU. This approach centers around new oversight of broad, system-wide risks and a higher-level of coordination among national supervisors involved in day-to-day oversight.

²¹ *Driving European Recovery*, Communication for the Spring European Council, Commission of the European Communities, April 3, 2009.

²² *Report*, The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosiere, February 25, 2009, p. 10.

²³ *Ibid.*, p. 11.

The de Larosiere Report recommended that the EU create a new macro-prudential level of supervision called the European Systemic Risk Council (ESRC) chaired by the President of the European Central Bank, as indicated in **Figure 2**. This proposal was adopted by the European Commission with some changes, including changing the name to the European Systemic Risk Board (ESRB). A driving force behind creating the ESRB was that it would bring together the central banks of all of the EU members with a clear mandate to preserve financial stability by collectively forming judgments and making recommendations on macro-prudential policy. The ESRB will also gather information on all macro-prudential risks in the EU, decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macroeconomic and prudential developments, and give direction on the aforementioned issues.

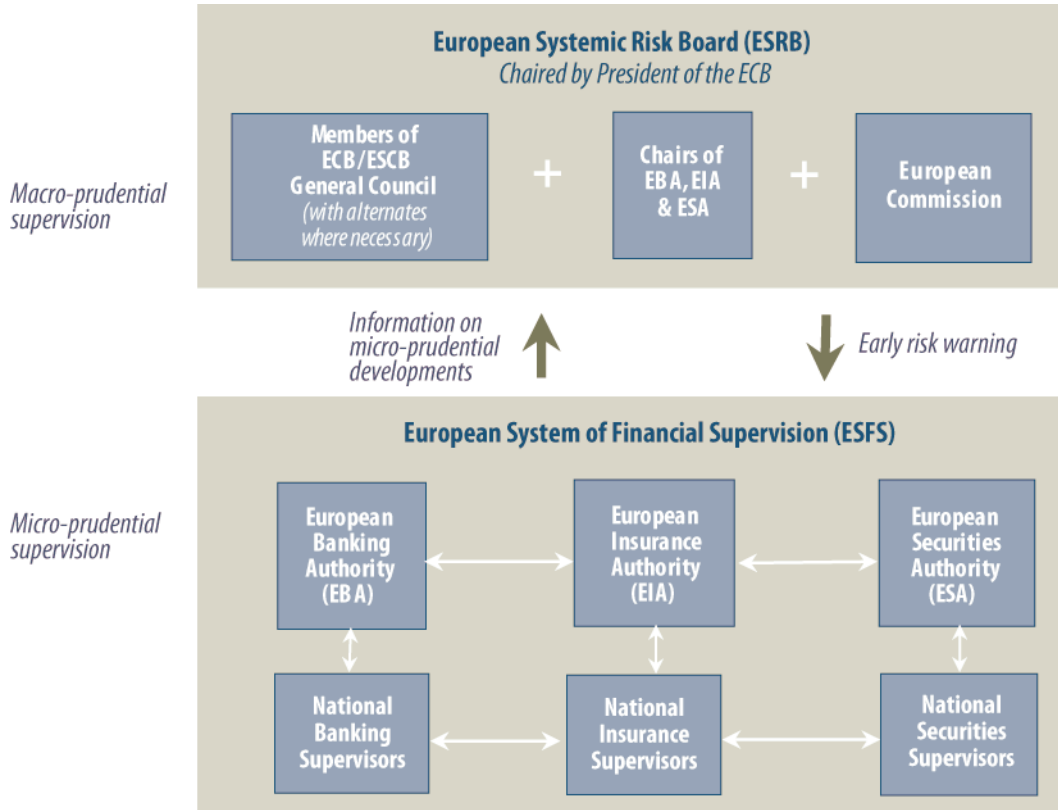
The EC also followed the report's recommendation to create a new European System of Financial Supervision (ESFS) to transform a group of EU committees known as L3 Committees²⁴ into EU Authorities. The three L3 Committees are the Committee of European Securities Regulators (CESR); the Committee of European Banking Supervisors (CEBS); and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The ESFS will maintain the decentralized structure that characterizes the current system of national supervisors, while the ESFS will coordinate the actions of the national authorities to maintain common high level supervisory standards, guarantee strong cooperation with other supervisors, and guarantee that the interests of the host supervisors are safeguarded.

Under this system, the European Central Bank (ECB) will have no micro-prudential role in supervising banks, but it will lead efforts within the European System of Central Banks (ESCB)²⁵ on macro-prudential supervision. In part, these macro-prudential activities include: (1) analyzing financial stability; (2) developing an early warning system to signal the emergence of risks and vulnerabilities of the financial sector to specific shocks and to issues that have cross-border and cross-sector dimensions; and (3) developing macro-prudential requirements.

²⁴ Level 3 committees represent the third level of the Lamfalussy process the EU uses to implement EU-wide policies. At the third level, national regulators work on coordinating new regulations with other nations, and they may adopt non-binding guidelines or common standards regarding matters not covered by EU legislation, as long as these standards are compatible with the legislation adopted at Level 1 and Level 2.

²⁵ The European System of Central Banks is comprised of the European Central Bank, which represents those countries that have joined the Euro area, and the central banks of all of the members of the European Union.

Figure 2. European Financial Supervision in the de Larosiere Report



Source: Report, The High-Level Group on Financial Supervision in the EU, February 25, 2009.

The main tasks of the ESFS authorities are to provide legally binding mediation between national supervisors; adopt binding supervisory standards; adopt binding technical decisions that apply to individual institutions; provide oversight and coordination of colleges of supervisors; license and supervise specific EU-wide institutions; provide binding cooperation with the ESRB to ensure that there is adequate macro-prudential supervision; and assume a strong coordinating role in crisis situations. The main mission of the national supervisors would be to oversee the day-to-day operation of firms.

The report envisioned the creation of the ESFS as a multi-year process that would be accomplished in two stages, but this multi-year phase-in was adjusted by the EC to one year in the final legislation. The first stage would have taken a year and would have served to prepare the groundwork for the transformation of the EU supervisory system by strengthening the national supervisors, harmonizing national legislation, strengthening the Level 3 committees, and expanding the use of supervisory colleges. In the second stage, which was expected to take two years to accomplish, the level 3 committees were to be transformed into the three Authorities previously mentioned. In addition to continuing to perform the functions currently assigned to these committees,²⁶ the new European Authorities would (1) have the authority to resolve disputes between national supervisors regarding financial institutions operating across national

²⁶ These functions include: advising the European Commission on regulatory and other issues, defining overall supervisory policies, convergence of supervisory rules and practices, financial stability monitoring, and oversight of supervisory colleges.

borders; (2) be responsible for the licensing and direct supervision of some specific EU-wide institutions; (3) play a decisive role in the interpretation and development of technical standards; (4) be responsible for establishing supervisory standards and practices; (5) work closely with the ESRC to assure that the ESRC can carry out its responsibilities for macro-prudential supervision; (6) facilitate exchanges of information in crisis situations and act as a mediator when necessary; and (7) represent EU interests in bilateral and multilateral discussions relating to financial supervision.

The de Larosiere Report also considered a framework for dealing with distressed or failing banks, especially when those banks have a presence across several national jurisdictions. Typically, the report argued, distressed or failing banks should be handled by national central banks, where they exist, because central banks likely would be the first to see signs of trouble. However, inconsistent crisis management and resolution tools across the EU compound efforts to contain bank crises. Similarly, EU governments have adopted different deposit guarantee schemes that are inconsistent across the EU and seem to be geared toward a minimum coverage level. This inconsistent approach worsens the shift of deposits among banks during periods of perceived weakness and raises the prospect that banks of different national origin that operate within a single country could offer different levels of depositor protection within the same country. As a result of extensive cross-border branching by some banks, the report proposes that national supervisory authorities have the authority to inquire whether the home countries maintain sufficient deposit guarantees that they can protect the deposit of bank branches in host countries. In those cases where the deposit guarantee schemes are not sufficient, the report proposes that national supervisory authorities have the ability to curtail the cross border expansion of banks into their jurisdictions until such deposit guarantees are provided.

The final section of the de Larosiere Report focused on the role of financial sector supervision in the context of highly integrated and interconnected global financial markets in which financial problems can be transmitted quickly around the globe. The report argued that the EU should take a leading role in reforming the international financial architecture by improving its own regulatory and supervisory system. Next, the report argued that the EU should promote international consistency of regulatory standards by strengthening bilateral dialogues on regulation among the main financial centers and by providing a clear mandate for international institutions that determine standards. In particular, the report argues that a strengthened and broadened Financial Stability Forum (now the Financial Stability Board) would be in the best position to coordinate international work on standards. The report also recommended that there should be international colleges of supervisors that can supervise large complex cross-border financial groups. In addition, the Report recommended that central banks should monitor more closely the growth in monetary and credit aggregates and there should be greater macroeconomic surveillance to monitoring macroeconomic policies, exchange rates and global imbalances. In addition to strengthening the IMF's existing macroeconomic surveillance mechanism, the International Monetary Fund (IMF) and the FSF would be tasked with placing greater emphasis on macro-prudential concerns to provide an early warning system that would be intended to help prevent financial crises. In case another financial crisis should appear, the report recommended that there should be clear multilateral arrangements for coordinating national responses.

Driving European Recovery

“Driving European Recovery,” issued by the European Commission (EC), presented a slightly different approach to financial supervision and recovery than that proposed by the de Larosiere group, although it accepts many of the recommendations offered by the group. This approach

ultimately was adopted by the EU. The recommendations in the report were intended to complement the economic stimulus measures that were adopted by the EU on November 27, 2008, under the \$256 billion Economic Recovery Plan²⁷ that funded cross-border projects, including investments in clean energy and upgraded telecommunications infrastructure. The plan was meant to ensure that “all relevant actors and all types of financial investments would be subject to appropriate regulation and oversight.” In particular, the EC plan noted that nation-based financial supervisory models are lagging behind the market reality of a large number of financial institutions that operate across national borders.

The EC praised the de Larosiere Report for contributing “to a growing consensus about where changes are needed.” Of particular interest to the EC were the recommendations to develop a harmonized core set of standards that can be applied throughout the EU. The EC also supported the concept of a new European body similar to the proposed European Systemic Risk Council, but named the European Systemic Risk Board, to gather and assess information on all risks to the financial sector as a whole. It also supported the concept of reforming the current system of EU Committees that oversee the financial sector. The EC plan, however, accelerates the plan proposed by the de Larosiere group by combining the two phases outlined in the report. Using the de Larosiere report as a basis, the EC intends to establish a new European financial supervision system. These efforts to reform the EC’s financial supervision system are based on five key objectives:

- First, provide the EU with a supervisory framework that detects potential risks early, deals with them effectively before they have an impact, and meets the challenge of complex international financial markets. The legislative package presented to the European Council, and adopted, includes two elements: measures to establish a European supervision body to oversee the macro-prudential stability of the financial system as a whole; and proposals on the architecture of a European financial supervision system to undertake micro-prudential supervision.
- Second, the EC intends to move to reform those areas where European or national regulation is insufficient or incomplete by proposing a number of items, including: (1) a comprehensive legislative instrument that establishes regulatory and supervisory standards for hedge funds, private equity and other systemically important market players; (2) a White Paper on the necessary tools for early intervention to prevent a similar crisis; (3) measures to increase transparency and ensure financial stability in the area of derivatives and other complex structured products; (4) legislative proposals to increase the quality and quantity of prudential capital for trading book activities and complex securitization; (5) proposals to address liquidity risk and excessive leverage; and (6) a program of actions to establish a more consistent set of supervisory rules.
- Third, to ensure European investors, consumers and small and medium-size enterprises can be confident about their savings, their access to credit and their rights, the EC will: advance a Communication on retail investment products to strengthen the effectiveness of marketing safeguards; provide additional

²⁷ *A European Economic Recovery Plan*: Communication From the Commission to the European Council, Commission of the European Communities, COM(2008) 800 final, November 26, 2008. The full report is available at http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf

- measures to reinforce the protection of bank depositors, investors, and insurance policy holders; and implement measures on responsible lending and borrowing.
- Fourth, in order to improve risk management in financial firms and to align pay incentives with sustainable performance, the EC intends to strengthen the 2004 Recommendation on the remuneration of directors and bring forward a new Recommendation on remuneration in the financial services sector, followed by legislative proposals to include remuneration schemes within the scope of prudential oversight.
 - Fifth, to ensure more effective sanctions against market wrongdoing, the EC intends to: review the Market Abuse Directive,²⁸ and make proposals on how sanctions could be strengthened in a harmonized manner and better enforced.

Conclusions

National authorities are searching for consensus on an international framework to supervise and regulate the complex international financial system. The financial crisis has demonstrated that financial markets are complex, highly integrated and interconnected. At the same time, there are important gaps in the current state of knowledge concerning the nature of the complex linkages that characterize international financial markets. There seems to be some consensus that any new financial architecture should correct the shortcomings of the current system by incorporating a number of features. These features include increased transparency, greater oversight over credit rating firms and underwriting standards, mark-to-market accounting, registration and supervision over hedge funds and other derivative markets, and some supervision of the credit default swap market. Beyond supporting increased supervision over these broad areas of market activities, policymakers remain divided over the specific ways that such supervision should be administered.

Some policymakers also argue that the international financial system can be strengthened through improvements in the data that are collected on financial activities. The Bank of England, for one, argues that the international financial system can benefit from collecting data on the international flow of funds comparable to the U.S. flow of funds accounts. These accounts provide data on financial linkages between domestic and foreign residents and between different parts of the financial sector and the real economy.²⁹ Policymakers are also focusing on the current size and structure of financial systems in which some institutions have such a far-ranging effect on the financial system that they are deemed to be too big to fail. Policymakers are weighing the benefits of having such firms hold higher amounts of capital and liquidity or limit their activities through regulation or oversight. This issue is particularly pressing for some European countries in which the size of some financial firms is greater than the national GDP and the failure of such firms can be highly destabilizing to the economy.

²⁸ The Market Abuse Directive was adopted by the European Commission in April 2004. The Directive is intended to reinforce market integrity in the EU and contribute to the harmonization of the rules against market abuse and establishing transparency and equal treatment of market participants in such areas as accepted market practices in the context of market manipulation, the definition of inside information relative to derivatives on commodities, and the notification of the relevant authorities of suspicious transactions.

²⁹ *Financial Stability Report*, The Bank of England, June 2009, p. 46.

Furthermore, academics and policymakers are assessing various proposals to address the tendency for the financial system and the real economy to act in a mutually reinforcing, or procyclical, manner. During periods of rapid economic growth and appreciation in the value of assets, the financial markets make credit more readily available, thereby reinforcing the economic boom and the prospects for an asset bubble. Similarly, as an economic boom ends and the real economy begins to slow down, credit markets tighten up, reinforcing the economic contraction. Central banks and policymakers are also focusing on methods and procedures to intervene with banks and other large financial firms that are facing insolvency or failure to provide for an orderly resolution of the firms to maintain market stability. The UK experience with a set of procedures it made permanent in February 2009 may prove useful to some policymakers. The EU acknowledges the importance of this issue, but it has left it up to individual EU members to develop their own approaches.

In the current environment, policymakers and academics also are reconsidering the role central banks play as systemic risk regulators. Central banks acted swiftly to address and contain the financial crisis, which has led some policymakers to weigh the benefits of expanding or amending the role of central banks in the supervision of financial markets. Expanding the role of central banks has some benefits, since central banks generally have the requisite economic resources, the political clout, and the ability to act quickly. Some policymakers, however, question the long-term impact of concentrating market power in an independent agency. In comparing across countries, the statutory role of the central bank is not clear and can vary substantially. As a result, some national governments apparently are considering altering the statutory authority of the central bank to make risk oversight a specific responsibility.

Appendix. Summary of Recommendations of the de Larosiere Report on EU Financial Market Supervision³⁰

1. Basel II rules should be amended to: (1) gradually increase minimum capital requirements; (2) reduce pro-cyclicality by encouraging dynamic provisioning of capital buffers; (3) introduce stricter rules for off-balance sheet items; (4) tighten norms on liquidity management; (5) strengthen rules for band internal control and risk management.
2. Adopt a common definition of regulatory capital, including which hybrid instruments should be considered as Tier 1 capital.
3. Relative to regulating credit rating agencies: (1) credit rating agencies should be regulated and supervised by a strengthened Committee of European Securities Regulators (CESR); (2) the credit rating agencies' business model should be reviewed and an assessment should be made of separating rating and advisory activities; (3) the use of ratings in financial regulation should be reduced; (4) distinct codes should be introduced for rating structured products.
4. Mark-to-market accounting rules should be reviewed to: (1) expedite solutions to the remaining accounting issues concerning complex products; (2) ensure they do not bias business models, promote pro-cyclical behavior, or discourage long-term investment; (3) allow the International Accounting Standard Board (IASB) or other standards setting groups clarify and agree on a common, transparent methodology for valuing assets in illiquid markets; (4) have the IASB open its standard-setting process to regulatory, supervisory, and business communities; (5) strengthen the IASB's oversight and governance structure.
5. The Solvency 2 Directive³¹ regulations on insurers and reinsurers should be adopted and include a balanced group support regime, coupled with sufficient safeguards for host member states, a binding mediation process between supervisors, and established harmonized insurance guarantee schemes.
6. Competent authorities in all member states must have sufficient supervisory powers, including sanctions, to ensure the compliance of financial institutions with the rules, and they must be equipped with strong, equivalent, and deterrent sanctions to counter all types of financial crimes.
7. Relative to the "parallel banking system" (hedge funds, investment banks, other funds, and mortgage banks): (1) appropriate regulations should be extended to all firms or entities conducting financial activities of a potentially systemic nature; (2) transparency should be improved, especially for systemically important hedge funds; there should be capital requirements on banks owning or operating hedge funds.

³⁰ *Report*, The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosiere, February 25, 2009.

³¹ The Solvency II Directive attempts by 2012 to bring insurers and reinsurers under the same regulatory regime that will provide a single set of rules that govern what constitutes an acceptable level of insurer creditworthiness.

8. Securitized products and derivatives markets should: (1) simplify and standardize over-the-counter derivatives; (2) introduce and require the use of at least one well-capitalized central clearing house for credit default swaps in the EU; (3) guarantee that issues of securitized products retain on their books for the life of the instrument a meaningful amount of the underlying risk.
9. Common rules should be developed for investment funds, including definitions, codification of assets and rules for delegation, accompanied by tighter supervisory control over the independent role of depositories and custodians.
10. Member states and the European Parliament should work toward greater harmonization in rules by avoiding legislation that permits inconsistent transposition and application, and they should identify national exceptions that would improve efficiency by their removal, reduce distortions of competition and regulatory arbitrage, or improve the efficiency of cross-border financial activity in the EU.
11. Compensation incentives must be better aligned with shareholder interests and long-term firm-wide profitability by basing the structure of financial sector compensation schemes on the following principles: (1) bonuses should be set in a multi-year framework; (2) the same set of rules should be applied to proprietary traders and asset managers; and (3) bonuses should reflect actual performance and not be guaranteed in advance.
12. Internal risk management should be: independent and responsible for effective, independent stress testing; senior risk officers should hold a very high rank in the company; and internal risk assessment and proper due diligence must not be neglected by overreliance on external ratings.
13. The EU should have a coherent and workable regulatory framework for crisis management; a framework that is transparent; the relevant authorities should be equipped with appropriate and equivalent crisis prevention and crisis management tools; and legal obstacles that prevent the use of these tools in a cross-border crisis should be removed.
14. Deposit Guarantee Schemes should be harmonized and prefunded by the private sector and provide high, equal protection to all bank customers throughout the EU; the schemes should protect all customers; and the existing authorities of host countries regarding cross-border bank branches should be reviewed.
15. Member states should agree on more detailed criteria for burden sharing (providing financial aid from the public and private sector) than those contained in existing agreements.
16. The EU should create a new body called the European Systemic Risk Council (ESRC) to pool and analyze all information, relevant for financial stability, pertaining to macro-economic conditions and to macro-prudential developments in all the financial sectors.
17. The EU should put in place an early warning system under the auspices of the ESRC and of the Economic and Financial Committee (EFC) to: (1) prioritize and issue macro-prudential risk warnings; (2) direct risks that potentially could affect the financial sector or the economy to the EFC to implement a strategy to address those risks; (3) warn the IMF, the FSF, and the BIS if risks relate to global

- dysfunction of the monetary and financial system; and (4) take additional action if the response of a national supervisor is inadequate.
18. A European System of Financial Supervisors (ESFS) should be established to: (1) work with the existing national supervisors who would continue to carry out day-to-day supervision; (2) replace three existing structures (Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and the Committee of European Securities Regulators (CESR) with three new European Authorities tasked with coordinating supervisory standards and guaranteeing strong cooperation between national supervisors; also (3) colleges of supervisors should be established for all major cross-border institutions.
 19. National supervisory authorities should be strengthened to upgrade the quality of supervision, including: (1) reforming national systems by aligning supervisors' competences and powers on a comprehensive system in the EU, increasing supervisors' remuneration, facilitating exchanges of personnel between the private sector and supervisory authorities, and ensuring that all supervisory authorities implement a modern and attractive personnel policy; and (2) intensifying the training and personnel exchanges of the level 3 committees; carrying out an examination of the degree of independence of all national supervisors.
 20. The EU should develop a more harmonized set of financial regulations, supervisory powers, and sanctioning regimes.
 21. The level 3 committees (national regulators) should: (1) gain a significant increase in their resources; (2) upgrade the quality and impact of peer review processes; (3) prepare for establishing supervisory colleges³² for all major cross-border financial firms in the EU by the end of 2009.
 22. The EU should establish an integrated European System of Financial Supervision (ESFS) and the level 3 committees should be transformed into three European Authorities – a European Banking Authority, a European Insurance Authority, and a European Securities Authority – with boards comprised of the chairs of the national supervisory authorities and have their own autonomous budget and a set of key competencies that include: legally binding mediation between national supervisors; adoption of binding supervisory standards; and binding technical decisions applicable to individual financial institutions.
 23. Planning for an integrated European System of Financial Supervision should begin immediately with a detailed plan for implementation developed before the end of 2009.
 24. The ESFS should be reviewed within three years of its implementation and additional reforms considered.
 25. The Financial Stability Board should be in charge of promoting the convergence of international financial regulation to the highest benchmarks, the Board should

³² Supervisory colleges are intended to be a formal structure that brings together the relevant national authorities under a lead supervisor to coordinate policies on cross-border financial activities.

- be enlarged, it should report to the IMF, and it should be transformed into a decision-making Council.
26. Supervisory colleges for large complex, cross-border financial groups should carry out robust, comprehensive risk assessments, should pay greater attention to banks' internal risk management practices and should agree on a common approach to aligning incentives in private sector remuneration schemes.
 27. The IMF should be placed in charge of developing and operating a financial stability early warning system, accompanied by an international risk map and credit register.
 28. Efforts should be intensified to encourage jurisdictions that currently are poorly regulated or "uncooperative" to adhere to the highest level of international standard and to exchange information among supervisors. Supervisors should increase capital requirements for those financial institutions that are investing in or doing business with poorly regulated jurisdictions.
 29. EU members should show their support for strengthening the role of the IMF in macroeconomic surveillance and to contribute towards increasing the IMF's resources in order to strengthen its capacity to support member countries facing acute financial or balance of payment distress.
 30. The EU should organize itself so it can represent itself in a coherent manner in the new global economic and financial architecture.
 31. In its bilateral relations, the EU should intensify its financial regulatory dialogue with key partners.

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