Supervision architecture in the EU: European System of Financial Supervision

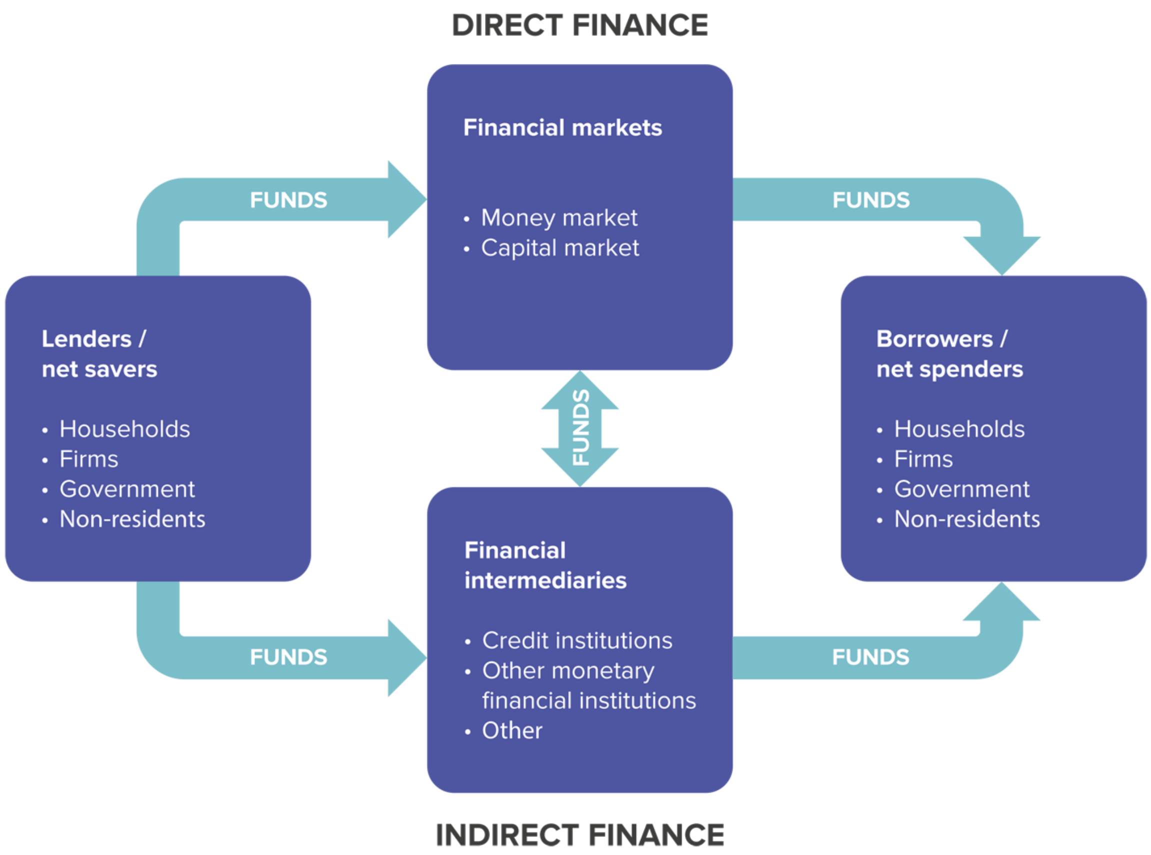
DG FISMA

These slides accompany the explanation of the acquis to Albania and North Macedonia and can only be used for that purpose. Their content is subject to further development of the acquis and interpretation by the Court of Justice of the European Union

Contents

- Introductory remarks on the financial system, regulation and supervision
- Micro-prudential supervision
- Macro-prudential oversight

Financial system: a stylised representation



Financial system: a stylised representation

- *Financial systems allow funds to be allocated, invested, or moved between economic sectors => **Enable economic activity***

- *Market failures*
  - *Asymmetric information*
    - *Adverse selection (ex ante)*
    - *Moral hazard (ex post)*
  - *Agency problem*
  - *Externalities*

- *Features that lead to inherent instability*
  - *Maturity mismatch gives rise to liquidity risk => (bank) runs*

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Financial regulation

- ***Prudential regulation**: Ensure soundness of financial system and its constituent parts*
  - Prevent financial panics/runs and avoid costly disruptions: central banks as lenders of last resort and deposit insurance
  - Ensure/induce prudent behaviour: incentive alignment (capital requirements, restrictions on assets and activities) and transparency requirements (reporting requirements), licencing, etc.

- ***Ensure functioning** (address market failures) by increasing information to investors*

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Structure of financial regulation and examples

- Entity-based/Sectoral perspective
  - **Banking**: Basel framework => Capital Requirements Regulation (CRR)/ Capital Requirements Directive (CRD)
  - **Investment funds**: Money Market Funds Regulation (MMFR), Alternative Investment Fund Managers Directive (AIFMD), UCITS,…
  - **Insurance**: Solvency
- Activity-based/Cross-sectoral issues
  - Securitisation (Simple,Transparent and Standardised Securitisation Regulation)
  - Repos (Securities Financing Transactions Regulation)
- Financial market conduct and securities
  - Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR)
  - European market infrastructure regulation (EMIR)

National Competent Authorities

"Member States shall designate the competent authorities which are to carry out the duties provided for in this [legal act]."

⇒***National Competent Authority (NCA)*** *= Supervisor*

- *Supervisory set-up differs across Member States*
  - *Multiplicity of NCAs (potentially)*
  - *Different supervisory models:*
    - *Single supervisor (Financial Supervisory Authority)*
    - *Sectoral approach*
    - *Functional approach (twin-peaks), etc.*
  - *Role of National Central Bank (NCB)*

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Examples of supervisory set-ups in EU

	Ireland (Single supervisor)	Belgium (Twin-peaks)	Germany
Credit institutions	Central Bank of Ireland	National Bank of Belgium	BaFin (Federal Financial Supervisory Authority) + Bundesbank
Insurance	Central Bank of Ireland	National Bank of Belgium	BaFin + Supervisory authorities of the Federal States
Investment funds	Central Bank of Ireland	Financial Services and Markets Authority	BaFin
Market conduct	Central Bank of Ireland	Financial Services and Markets Authority	BaFin

Contents

The European System of Financial Supervision (ESFS)

European System of Financial Supervision (ESFS)

Micro-prudential supervision

ESAs
ESMA, EBA and EIOPA

Joint Committee

Micro-prudential supervisory authorities (NCAs & ECB/SSM)

Macro-prudential oversight

European Systemic Risk Board (ESRB)

ECB (SSM) / NCBs

National macro-prudential authorities

Commission

The European Supervisory Authorities ("ESAs")

European Banking Authority (EBA)

European Insurance and Occupational Pensions Authority (EIOPA)

European Securities and Markets Authority (ESMA)

The European Supervisory Authorities ("ESAs")

Objective is to contribute to the effectiveness of the financial system.

Mandate is to contribute to the Single Rulebook; promote consistency in supervisory actions and the consistent application of Union law; some direct supervision.

The ESAs; structure

Sectoral architecture.

Supervisor of supervisors.

National supervisors carry out day-to-day supervision.

Member State authorities make up the decision making body.

What the ESAs do

"Regulatory" activities

- Regulatory technical standards that the Commission endorses
- Guidelines to supervisors and industry
- Recommendations to supervisors and industry
- Opinions to industry and sometimes supervisors

What the ESAs do *cont.*

"Supervisory activities"

- Promote a common supervisory culture/convergence of supervisory practices;
- Ensure the consistent application of legally binding Union acts;

What's next

Ongoing review to improve effectiveness and efficiency of the ESA framework.

Brexit raises challenges as the EU is left more fragmented and exposed.

Continued market integration requires more supervisory integration.

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Objective of macro-prudential policy

Limit systemic risk *through the* ***use of primarily prudential tools***

- *Systemic risk: "… the risk of widespread disruption to the provision of financial services that is caused by an impairment of all or parts of the financial system, and which can cause serious negative consequences for the real economy…"*
- *Macro-prudential tools: mainly capital buffers*

Economic justification: Correct externalities (market failures), internalised by neither market actors nor micro supervisors

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Macro-prudential policy toolkit

CRD IV/CRR framework

Countercyclical capital buffer (CCyB)
Additional capital requirement

Systemic risk buffer (SRB)
Additional capital requirement

G-SII/O-SII buffer
Additional capital requirement

Pillar II measures
Additional capital requirements due to SREP

Article 124/164 CRR
Risk-weight calibration for real estate exposure

Article 458 CRR 'Flexibility package'
Wide range of measures

Additional national measures

Real estate measures
Loan-to-value caps, Debt-service-to-income caps, amortisation caps, etc.

Stress/sensitivity tests
Interest rate increase impact on specific portfolios

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Complements other policy areas pertaining to financial stability

- **Micro-prudential policy**
  - Perspectives differ (institution vs system)
  - Complementary, despite potential tensions (tightness of regulatory requirements through cycle; fallacy of composition)
- **Monetary policy**
  - Complementary: addresses "leaning vs cleaning" dilemma (financial vs price stability)
  - Decentralised implementation vs one-size-fits-all
- **Competition and tax policy…**
  - …to the extent that they fuel risks (e.g. tax credits; competition-induced risk-taking)

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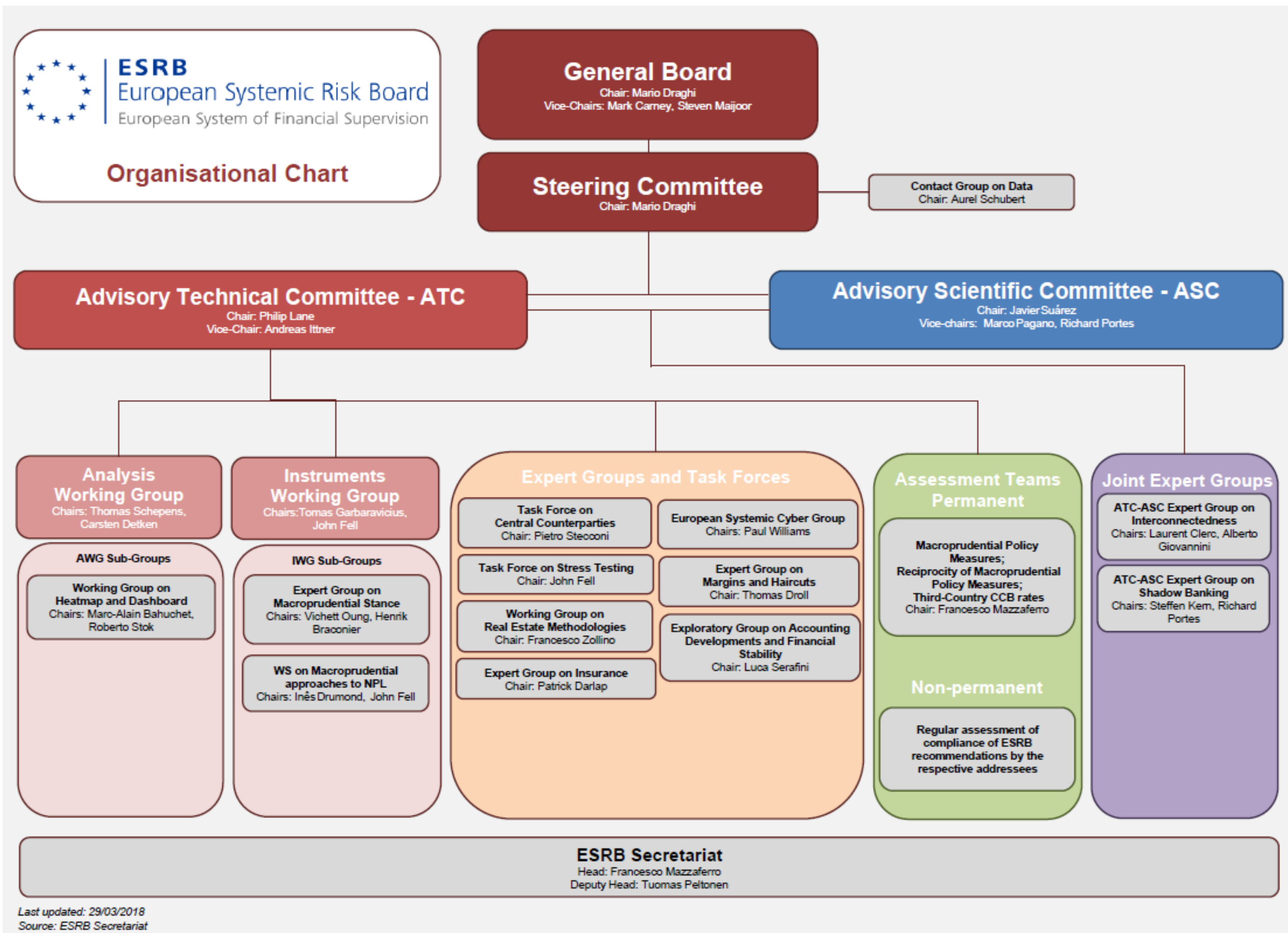
Macro-prudential policy in the EU: Centralised oversight by the European Systemic Risk Board (ESRB)

- **Mandate: macro-prudential oversight of the EU financial system**
  - Objective: Prevention or mitigation of systemic risks to financial stability to ensure a sustainable contribution of the financial sector to economic growth
  - Macro-prudential => broad view beyond individual institutions
  - Oversight => directing others to act
  - Financial system => looking beyond the banking sector
  - Co-ordination role and information hub
- **Tools/powers: Warnings and Recommendations**
  - Addressed to the Union as a whole, Member States, ESAs, national supervisory authorities
  - No direct decision-making power ("soft power"): "comply or explain”

ESRB – composition and structure



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ESRB – composition and structure

- *A large and inclusive General Board as a decision making body*
  - Includes national central banks, supervisors, Commission, EFC & ESAs
  - 67 members (38 with voting rights)
- *Chaired by ECB President*
- *Supported by a secretariat as hosted by the ECB*
  - Provides analytical, policy & administrative support
- *Analysis supported by the ECB and member institutions*
- *Organised in an extensive structure of working groups covering various dimensions and sources of systemic risk*

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Decentralised implementation of macro-prudential policy – subject to coordination and control mechanism

- *(Most) macro-prudential instruments under CRR/CRD are allocated to national "designated authorities"*
  - Prominent role of NCBs
  - Coordination with NCAs desirable (if different)

- *EU coordination and control: Activation of measures generally subject to notification and - depending on tool and intensity - approval procedures*
  - E.g. approval of measures under Article 458 (framework of constrained flexibility) involves (ECB), ESRB, EBA and COM
  - Reciprocation framework (via ESRB Recommendation)

- *ECB has top-up power in the Banking Union (Article 5 of SSM Regulation)*
  - Avoid inaction bias

Examples of supervisory set-ups in EU

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Insurance	Central Bank of Ireland	National Bank of Belgium	BaFin + Supervisory authorities of the Federal States
Investment funds	Central Bank of Ireland	Financial Services and Markets Authority	BaFin
Market conduct	Central Bank of Ireland	Financial Services and Markets Authority	BaFin
National designated authority	Central Bank of Ireland	National Bank of Belgium	BaFin (with Bundesbank involvement)
Macro-prudential authority	Central Bank of Ireland	National Bank of Belgium	Ausschuss für Finanzstabilität (Financial Stability Committee)

Example: ESRB Warnings on medium-term vulnerabilities in the residential real estate sector

- Assessment based on analysis of three "stretches": Income stretch (households); Collateral stretch (market); Banking system stretch
- September 2016: ESRB warnings on medium-term risks related to residential real estate in eight Member States (AT, BE, DK, FI, LU, NL, SE, UK)
- Accomodative monetary policy: low interest environment
- Follow-up in some countries (not all) via targeted **macro-prudential measures**, some under **Art. 458 CRR** (BE, FI, SE)
- **Variety of measures:** These include risk-weight floors or add-ons for mortgages (FI, BE), amortisation requirements (SE), loan-to-value and debt-to-income ratios (DK; LU)
- EU **European Semester surveillance** has housing-market related country specific recommendations (e.g. NL, SE)
- **ESRB** to **follow up** on the warnings in the second half of 2018

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Example: ESRB Recommendation on liquidity and leverage risks in investment funds

- Analysis carried out by Expert Group on Investment Fund liquidity and leverage
- December 2017: Recommendations addressed to Commission and ESMA

- A. Ensure availability of liquidity management tools for fund managers
- B. Provisions to reduce the likelihood of excessive liquidity mismatches
- C. Guidance on the practice to be followed by managers for the stress testing of liquidity risk for individual funds
- D. Assessment of leverage limits to address build-up of systemic risk in the financial system
- E. Additional reporting by funds

Review of the European Systemic Risk Board

On 20 September 2017, the Commission adopted a proposal to **amend Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board**.

Objective is to **preserve and build on the existing framework**, via a set of **targeted changes to the ESRB's governance**

- **ESRB Chair**: ECB President on a permanent basis
- **Reflect establishment of the Banking Union**: Single Supervisory Mechanism and the Single Resolution Board added as voting members
- **ESRB warnings and recommendations**: ECB (banking supervision) added to list of potential addressees; systematic notification to European Parliament and ESAs
- **Head of the ESRB Secretariat**: more transparent appointment procedure; clarification of tasks; possibility to represent ESRB externally
- More **stakeholder consultations**