

Sapir, André et al.

**Research Report**

## The consequences of the single supervisory mechanism for Europe's macro-prudential policy framework

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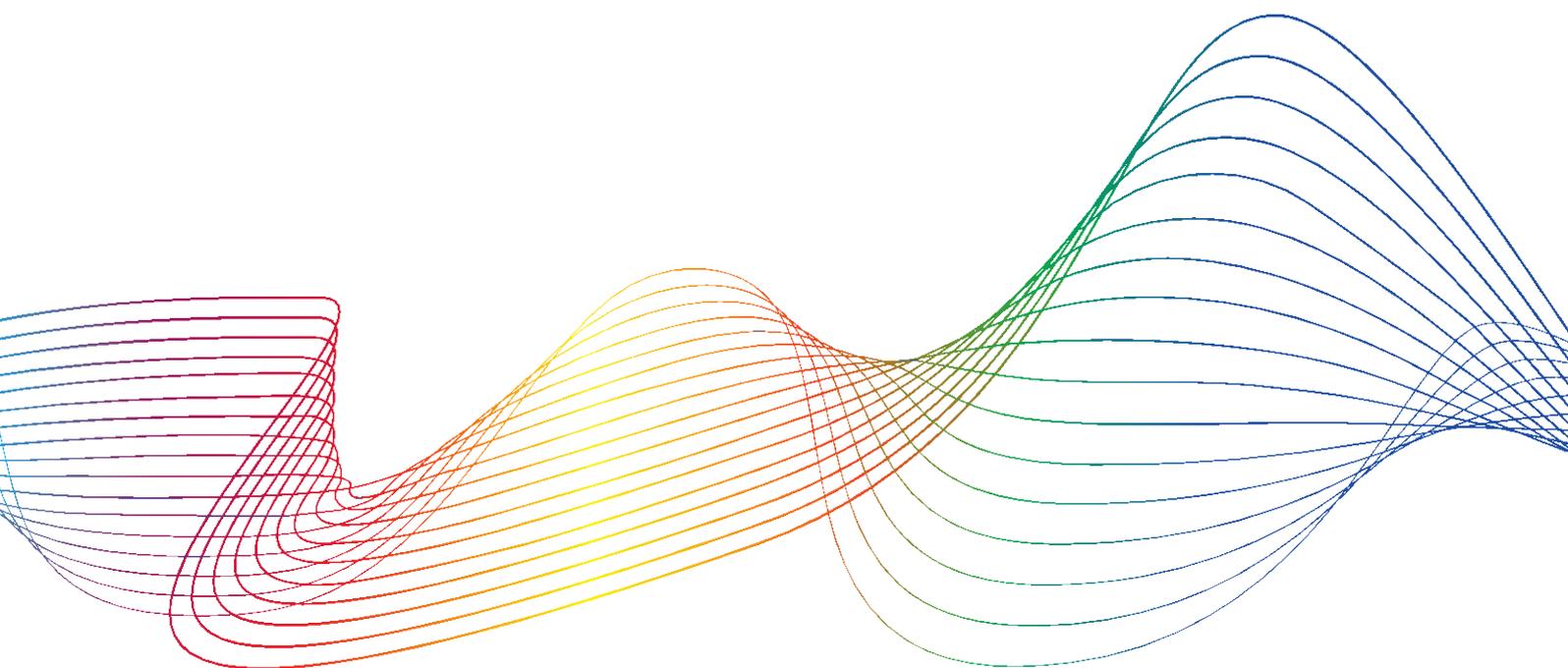
# Reports of the Advisory Scientific Committee



**ESRB**  
European Systemic Risk Board  
European System of Financial Supervision

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## The consequences of the single supervisory mechanism for Europe's macro-prudential policy framework



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## The consequences of the single supervisory mechanism for Europe's macro-prudential policy framework

### I. Introduction

1. The European macro-prudential policy framework that was set up in 2010 – a year after the de Larosière report on financial supervision in the EU – operates at two levels. At the EU level, the ESRB has a legal responsibility for macro-prudential oversight and the prevention and mitigation of systemic risks to the EU financial system. To this aim, the ESRB can issue warnings and recommendations, which are subject to a “comply or explain” mechanism. It also has consultative powers in a broad set of areas. However, the ESRB does not have the power to use other instruments directly. That responsibility lies either at the national level, subject to EU constraints that prohibit the loosening of micro-prudential ratios, or at the European level.
2. There are two reasons why the responsibility for the adoption of the measures necessary to maintain financial stability – either upon the initiative of national macro-prudential authorities or in response to ESRB recommendations and warnings – was primarily vested to national rather than EU authorities.
3. One reason was inherently macro-prudential in nature. Financial and macroeconomic cycles, and the structural characteristics of financial systems, still differ a great deal between EU countries in spite of EU financial integration. The divergent economic conditions within Europe over the past decade illustrate these differences. Thus it may make sense for different countries to operate somewhat distinct macro-prudential policies to control the timing of aggregate credit expansion and contraction within their borders. Even in the euro area, where financial markets are more integrated than in the EU as a whole, a one-size-fits-all approach to macro-prudential policy, which would pretend that economies are all experiencing synchronised changes in credit market, asset market and growth conditions, is undesirable.
4. The other reason was the political economy of financial sector supervision and resolution in Europe. Despite having built an integrated EU financial market, national authorities still retained full and sole control over financial supervision and crisis resolution. This was mainly due to the fact that financial crises typically have a substantial impact on public finances, the responsibility for which lies at the national level in the absence of a self-funded European mechanism.
5. The decentralisation of regulatory and supervisory authority, including macro-prudential policy-making, entailed significant risks that were not addressed initially. In particular, the recognition of losses in a predictable and transparent manner, and their allocation across the various national authorities or financial institutions in the context of cross border resolution inherently requires coordination and agreement among national authorities. Postponing such agreement and postponing the creation of a European resolution mechanism would ultimately mean no workable resolution process at all, with the result that resolution may be chaotic when it is tried or resolution is not tried at all for fear of creating chaos.
6. Two recent developments could favour the required coordination among EU countries. One is the ESRB recommendation establishing common guidelines for national macro-prudential

authorities, to be complemented by a further ESRB recommendation on an indicative list of macro-prudential tools. The other is the Commission proposal to create an EU framework for the recovery and resolution of financial institutions by competent national authorities. But these developments fall far short of what is necessary to ensure the consistent application of macro-prudential rules and the viability of resolution regimes in different countries, including the maintenance of integrated operations of banks with subsidiaries in different countries and ex ante coordination on loss-sharing between these countries.

7. The creation of a European banking union offers the prospect to solve the coordination problem by putting in place, on top of national supervisors and national resolution authorities, a European supervisor and a European resolution authority. A European deposit guarantee mechanism, acting as a complement to national deposit insurance systems, should also become part of the banking union in due time.
8. In December 2012 the Council agreed on a regulation creating a single supervisory mechanism (SSM) which will be responsible for the micro- and macro-prudential supervision of all banks in the countries participating in the SSM. The SSM will be composed of the European Central Bank (ECB) and the national competent authorities (NCAs), with the ECB acting as European supervisor “responsible for the effective and consistent functioning” of the SSM. It is too early at this stage to know how many countries will participate in the SSM, but all euro area countries will join and probably the majority of non-euro area EU countries as well.
9. In its report of October 2012 (No 2/October 2012), the Advisory Scientific Committee (ASC) of the ESRB commented on the SSM and on the necessity to supplement it with the creation of a single resolution mechanism, and later on with a single deposit guarantee scheme.
10. Here we focus on the implications of the SSM for the macro-prudential policy framework in Europe, a subject that was already addressed by the High-Level Group (HLG) on the ESRB Review, of which the ASC Chair was a member.<sup>1</sup> The purpose of this report is to make suggestions on matters either not addressed by the HLG or which the ASC consider worthy of further comments.
11. The remainder of the report is divided into two sections. The first examines how macro-prudential policy could be organised within the SSM. The second looks at the implications of the SSM for the role of the ESRB as the EU body responsible for identifying, monitoring and mitigating systemic risks to the stability of the EU financial system.

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<sup>1</sup> The HLG is composed of the Vice-President of the ECB and the chairs of the Advisory Technical Committee and the Advisory Scientific Committee of the ESRB.

## II. Macro-prudential policy within the SSM

12. The SSM will have extensive powers over both micro- and macro-prudential policies, but with different divisions of responsibility between the ECB and the NCAs in the two areas. This section addresses two questions about the organisation of macro-prudential policy within the SSM: (i) what should be the division of responsibility between the ECB and the NCAs in the conduct of macro-prudential policy?; and (ii) what should be the relationship between macro- and micro-prudential policies?
13. Starting with the question regarding the division of responsibility, we note that, in principle, two models, with different levels of centralisation, are possible.
14. In a decentralised model, the ECB would set the macro-prudential framework (including the overall design of the policy strategy on how to use macro-prudential tools) and the NCAs would apply the tools in their respective countries. Nonetheless, the ECB would have effective control over the use of tools since it has the right, according to Article 4a (2) of the draft SSM regulation, to set higher requirements than the national authorities.
15. In a centralised model, the ECB would not only set the macro-prudential framework, but would directly apply the macro-prudential tools in cooperation with the NCAs. The main task of the NCAs would be to provide information about their national business/housing cycle conditions and to make recommendations to the ECB, which would take the final decision using its powers under Article 4a (2) of the draft SSM regulation.
16. The decentralised model is closer to the spirit of the text. Nonetheless, we favour the centralised model for reasons of coherence. The ECB should be in charge of macro-prudential policy since it will be in charge of the micro-prudential instruments which will be used for macro-prudential purposes.
17. It should be emphasised, however, that the ECB's powers only apply to macro-prudential tools provided for in relevant acts of Union law, in particular the Capital Requirements Regulation and Directive (CRD IV). Those that are not provided for in such acts cannot, by definition, be conferred on the ECB by the SSM regulation and will therefore remain entirely under the responsibility of the national authorities. In addition, the SSM may only apply instruments related to the banking sector. Hence, even the centralised model would only be partially centralised.
18. In general, the centralised model should not lead to the uniform application of macro-prudential tools across the countries in the SSM since they would be expected to face different business or housing cycles. However, in some instances, the ECB may wish to apply (or to encourage NCAs to apply) a uniform macro-prudential requirement when the price of a particular asset is increasing too quickly in a large number of SSM countries.
19. With regards to the question about the relationship between macro- and micro-prudential policies, we begin by noting that there is often a trade-off between the two. For instance, selling an asset when its risk price increases may be a prudent response from the viewpoint of an individual financial institution, but could have detrimental consequences for the stability of

the financial system if many individual institutions act in a similar fashion. In such circumstances, macro-prudential concerns should override micro-prudential ones.

20. The potential conflict between micro- and macro-financial stability has implications for the organisation of macro- and micro-prudential policies within the ECB. In particular, it raises the question as to whether the same body within the ECB should be in charge of both policies. The planning and execution of supervisory tasks by the ECB will be undertaken by a newly-created Supervisory Board composed of a chair, a vice-chair (chosen from among the members of the Executive Board of the ECB), four representatives of the ECB and one representative of each country participating in the SSM. Decisions by the ECB's Supervisory Board will need to be validated by the Governing Council of the ECB.
21. Two models for the organisation of micro- and macro-prudential decisions within the ECB are possible.
22. One model would be to prepare both micro- and macro-prudential decisions within the Supervisory Board, which would then have to be validated by the Governing Council. There are advantages with this approach in terms of coherence, but there is also a major drawback. Since discussions in the Supervisory Board are likely to be dominated by micro-supervisory issues relating to individual banks, the Board might lose sight of, or give too little weight to, macro-prudential considerations.
23. Another model would be to have a more active involvement of the Governing Council in macro-prudential decisions. In the most extreme case – and deviating from the proposed legislation – one might propose a situation where micro-prudential decisions are prepared by the Supervisory Board (whose members are primarily financial supervisors dealing with micro risks) subject to validation by the Governing Council, while macro-prudential decisions are entirely discussed and decided by the Governing Council (whose members are central bankers who deal mainly with macro risks). We favour this option because it gives greater weight to macro-prudential considerations.

### III. The role of the ESRB in the new European macro-prudential policy framework

24. What are the consequences of the creation of the SSM for the ESRB? The answer depends on the perspective one adopts. It could be argued that the ESRB's remit is broader than the ECB's in some aspects, and narrower in others. It is broader since the ESRB covers the entire EU and the entire spectrum of financial activities, whereas the SSM only covers participating countries and banking activities. And it is narrower in the sense that it covers only macro-prudential oversight, whereas the SSM covers both micro- and macro-prudential supervision, meaning that the ESRB is more specialised than the SSM. Viewed from this perspective, one could conclude that there is little overlap between the ESRB and the SSM: they have a different coverage and specialisation. Hence, the creation of the SSM would have little consequence for the ESRB other than at the organisational level since the ECB, which has played an important role in the ESRB, will perform the central role in the SSM.



25. However, one could also argue that most EU countries will participate in the SSM and that banking is not just one, but the most important, financial activity in terms of systemic risk to the stability of the financial system. Moreover, since it will have powers over both micro- and macro-prudential supervision, the ECB will be able to directly implement macro-prudential policy rather than simply make recommendations or issue warnings, as is the case for the ESRB. Viewed from this perspective, one could conclude not only that there is a lot of overlap between the ESRB and the SSM, but also that the ECB will have far greater powers in macro-prudential policy than the ESRB. Hence, the creation of the SSM, in which the ECB will play the central role, would essentially make the ESRB irrelevant.
26. We would argue that one should adopt a third perspective, which combines elements of the previous two. The starting point should be that the ESRB is, indeed, the only EU-wide body in charge of macro-prudential supervision, that it covers all financial activities rather than only banking and that its only instruments are recommendations and warnings. As far as the latter is concerned, a distinction should be made between the two types of recommendation and warning that the ESRB can in principle issue. One concerns EU and national legislation that affects the financial stability of the EU system. The other concerns economic and financial developments in one or several EU countries that constitute a systemic risk to the stability of the EU system.
27. The creation of the SSM will have no impact on the first type of recommendation and warning. The ESRB is, and will remain, the best EU institution for proposing, or commenting upon, EU legislation from the macro-prudential perspective. This role of advocate of financial stability in EU legislation should be maintained and even reinforced. However, as already proposed by the HLG on the ESRB Review, the views of the ESRB should be requested prior to, rather than after, the adoption of legislative proposals which are likely to have a direct impact on systemic risk.
28. The more controversial question concerns the role of the ESRB in identifying, monitoring and issuing recommendations or warnings about systemic risks to the stability of the EU financial system that stem from developments in individual countries, especially when such countries belong to the SSM and when the risks pertain to the banking sector.
29. Should the ESRB have the effective capability to issue recommendations or warnings about developments in individual EU countries, including those in the SSM? The answer is yes, the ESRB should have this capability and it should apply equally to all countries whether or not they belong to the SSM. An ESRB that could only issue recommendations and warnings to the few countries expected to remain outside the SSM would effectively have no power at all.
30. The reason why the ESRB should have this capability is that it is the sole EU body with the power to prevent insufficient action on the part of national authorities, and of the ECB for the SSM countries, in mitigating systemic risk to the EU financial system. The fact that it has soft, rather than hard, power does not detract from its power. On the contrary, it is precisely because the ESRB does not wield an iron rod that it should speak loudly about the dangers of inaction in the face of mounting systemic risks.

31. How should the ESRB exercise its powers over SSM countries when issuing recommendations or warnings? The answer partly depends on whether the SSM adopts the centralised or decentralised model discussed in the previous section. Under the centralised model, recommendations or warnings about individual countries would be addressed primarily to the ECB, while under the decentralised model the principal addressee would be the relevant NCA. As far as macro-prudential tools not provided for in relevant acts of Union law are concerned, recommendations or warnings will always be addressed to the NCAs since, by definition, the SSM will have no power in that field.
32. The fact that the ECB will become a potential addressee of ESRB recommendations and warnings raises, as already noted by the HLG on the ESRB Review, a potential conflict of interest between the ECB and the ESRB. Such conflict would arise from the central role of the ECB within the ESRB, and in particular from the fact that the President of the ECB is also the Chair of the ESRB. Before the creation of the SSM, the ESRB as a young institution greatly benefited from having the President of the ECB as its chair. However, after the establishment of the SSM, this situation would create a conflict of interest which would be highly detrimental to the ESRB's ability to carry out its responsibilities.
33. Finally, an active role by the ESRB in identifying, monitoring and making recommendations or warnings about systemic risks to the stability of the EU financial system stemming from developments in individual countries would necessitate other important changes in the ESRB's modus operandi and governance, besides the question of its chair. There is a need to streamline the structure and enhance the effectiveness of the ESRB. Here, implementation of the proposals by the HLG on the ESRB Review is paramount to improve the current situation. In particular, improvement in the collection of data, in the ESRB's analytical capability and in its decision-making process is crucial. As far as the latter is concerned, the ASC suggests the creation of a post of Managing Director, who would act as the ESRB's chief executive officer. The Managing Director would carry out the policy determined by the General Board of the ESRB and would be responsible to the General Board for the management of the ESRB.
34. Having a Managing Director would help resolve two problems facing the ESRB, one current the other future. First, the interplay with and reporting to the Economic and Financial Committee (EFC) – emphasised in the de Larosière report – could be improved. This is important since the EFC prepares the work of the ECOFIN Council. The ESRB's Managing Director would represent, with authority, the ESRB to the EFC, where he/she would act as the advocate of and expert in macro-financial stability in the EU. The role of the ESRB's Managing Director would be similar to that of the European Stability Mechanism's Managing Director. Second, creating a post of Managing Director would help reinforce the identity of the ESRB, which will need to be more independent from the ECB in order to avoid possible conflicts of interest between the two institutions after the establishment of the SSM.

## Members of the ESRB Advisory Scientific Committee

André Sapir (Chair)

Université libre de Bruxelles, Brussels

Martin F. Hellwig (Vice-Chair)

Max Planck Institute for Research on Collective Goods, Bonn

Marco Pagano (Vice-Chair)

University of Naples Federico II, Naples

Viral V. Acharya

New York University Stern School of Business, New York

Leszek Balcerowicz

Warsaw School of Economics, Warsaw

Arnoud Boot

University of Amsterdam, Amsterdam

Markus K. Brunnermeier

Princeton University, Princeton

Claudia Buch

Halle Institute for Economic Research, Halle

Ieke van den Burg

Former Member of the European Parliament

Charles Calomiris

Columbia Business School, New York

Daniel Gros

Centre for European Policy Studies, Brussels

Dario Focarelli

Associazione Nazionale fra le Imprese Assicuratrici (ANIA – Italian Association of Insurance Companies)

Alberto Giovannini

Unifortune Asset Management SGR SpA, Milan

Dirk Schoenmaker

Duisenberg School of Finance, Amsterdam

Charles Wyplosz

Graduate Institute of International and Development Studies, Geneva