



Financial stability requires the implementation of macroprudential supervision alongside the individualised supervision of financial institutions. This involves analyzing the negative systemic implications for financial institutions as well as consumers and businesses that may be brought about by the

real economy's transformations and financial innovation or the formation of asset bubbles². This must enable a common reading of existing prudential rules and the identification of any further measures required. In this respect, it is important to note that despite a common prudential framework (Basle I), the deconsolidating nature of securitisation operations has not been treated in a consistent way by supervisors in Europe.

The financial crisis is providing various examples of shortcomings with the current macroprudential system. For instance, the procyclicality of prudential rules has been identified even when they were being drawn up, without the authorities admitting to this or trying to resolve it. Neither has the global systemic role gradually taken on by the two American mortgage agencies Fannie Mae and Freddie Mac been identified. The same is true for the consequences of the "originate to distribute" model on the quality of loans granted and the soundness of the banking system. The crisis is also showing that regulations have placed too much trust in the risk assessment models and ratings of the various players or their debt, which has contributed to the excessive credit growth seen. The excessive focus on ratings in investors' decisions has not been detected.

The reports drawn up by the Bank for International Settlements or Central Banks revealing insufficient risk pricing have not led to any corrective actions.

General conditions for effective macroprudential supervision

Objectives for macroprudential supervision

The first macro-prudential supervision's aim should be to clarify the risks of bubbles and define corrective measures that should be transmitted to the political decision-making bodies, including on a global level during the various global governance summits (IMF, G8, G20, etc.). This first mission naturally falls into central banks and macroeconomic institutions notably the BIS, IMF, OECD, ECB, etc.

In parallel, macroprudential supervision must assess the practices³ of the main players on the regulated or OTC markets, particularly CDS, CDOs, etc., and financial infrastructures. Macro-prudential supervision should also identify possible unlevel playing field issues between different market places in particular when these inconsistencies may lead to excessive risk taking.

Last macro-prudential supervision must supplement the natural microeconomic role of banking and insurance supervisors. It should be responsible for monitoring common changes and trends in institutions' business models and financial techniques and for assessing the new underlying risks. Macro-prudential supervision should then propose prudential measures (dynamic provisions, additional prudential capital etc.) that will make it possible to curb the negative trends seen. After being validated by the political authorities, such proposals would lead to the adoption of new rules.

Those missions must involve the market supervisors and the central banks but also requires additional and specific efforts. This macro-prudential supervision must primarily be achieved at national level since the systems for managing financial stability are still in most cases national (supervision of financial players, trading systems, consumer protection) and asset bubbles may only be seen on a domestic level. This must be carried out at the same time for the eurozone, the European Union and globally.

Political stakes

Treating bubbles and reducing the procyclicality of prudential rules involves major political stakes since they may have significant short-term consequences for financial players, their shareholders and all economic players: temporary drop in growth, targeted increase or reduction in access to borrowing, reduction in the return on capital, etc.

Under these conditions, it is particularly essential to highlight the need for close coordination on the implementation of these provisions between Member States in order to avoid any differences in corrective measures causing any distortion of competition. Before taking any decision, it also seems necessary to ensure that a suitable impact analysis is carried out for the various corrective measures being envisaged.

At the same time, the decision-making process must be organised in a balanced way. This is not only about ensuring that the dangers are recognised and that the palliative and corrective measures are in proportion, but also guaranteeing that the corrective measures are neither postponed nor toned down, particularly for political acceptability reasons.

¹ This Eurofi paper do not engage the Chairmen of Eurofi

² Asset bubbles may be sectoral or regional and concern real estate, commodities, equities, bonds, a country risk, etc.

System in charge of macroprudential supervision in Europe

As indicated previously, each country within the Union should set up an organisation that is in charge of national macroprudential supervision and factors in the objectives set out above.

At European level, beyond the transformation required by the improvement of micro prudential supervision⁴ CEBS, CEIOPS and CESR should have the powers and the means to centralise and analyse the sectoral data based on information provided by each national supervisory authority covering all domestic or cross-border financial players. They should be able to define corrective measures with the help of the EMPS staff (see below) and decided within this new Institution

In terms of banking, this work must be closely coordinated with the ESCB. Indeed, the European Union's central banks should more specifically watch for the appearance of and any changes in asset bubbles. Furthermore, the ESCB contributes towards the EU's financial stability and central banks are the lenders of last resort. That is why the ESCB could appoint a permanent representative within the CEBS.

Furthermore, the need to conduct inter-sector macro-prudential oversight at EU level suggests the creation of a specific institution. With specific staff, it could, in cooperation with members of CEBS, CEIOPS, CESR, the ESCB and the ECB and non-eurozone National Central Banks, be in charge of:

- Centralizing sector analyses and leading inter sector analyses in order to identify the new possible risks
- Identifying and preparing recommendations (monetary policy, general or specific (assets, type of players) solvency requirements...) for the for the National or European supervisory authorities and Central Banks, including related impact analyses
- Identifying the regulatory or legislative provisions that the Level IIIs or other EC institutions must implement - Commission, Parliament, Council
- Liaising with the equivalent international bodies that are in charge of global financial stability (Basle Committee, Financial Stability Forum, International Association of Insurance Supervisors, etc.)
- Drawing up an annual report for the European Parliament, Council and Commission, summarizing the macroprudential situation, outlining the recommendations made and reporting on progress made with and the consistency of their implementation.

The recommendations, whether they are intended for the supervisors, central bankers, legislators or regulators, should be combined with explicit deadlines.

This institution could possibly be created through a transformation of the existing Banking Supervisory Committee (BSC) created in 1998. This Committee comprises high-level representatives from the ECB and Eurosystem NCBs, as well as representatives from the national banking supervisory authorities in these Eurosystem countries where the NCB's mandate does not include banking supervision. In addition, the BSC includes the central bank and supervisory representatives from the EU countries that have not adopted the single currency.

Banking, insurance or market recommendations would be respectively proposed and decided on by the central bankers and banking supervisors, the insurance supervisors and the market supervisors. The Commission should be involved in all of the decisions to be taken. All of these players should be brought together for two annual meetings in order to enable intersectoral exchanges and cover the corresponding decisions. It is appropriate to analyse and decide at EU level the need to extend national countercyclical decisions to foreign financial institutions operating in the country concerned. This would contribute to avoiding any competitive distortions, while increasing the efficiency of such decisions.

To ensure the effectiveness of the governance, this entity, just like each member state, the ESCB, Commission, CEBS, CEIOPS and CESR, would have just one representative.

This new European Macro-Prudential Supervision Institution (EMPS) should group together the Commission (DG ECFIN in charge of economic and financial matters within the Commission), CEBS, CEIOPS, CESR, the members of the ESCB and a representative from each EU member state. Unlike the approach for the Lamfalussy process, it is this institution that would validate the action plans and recommendations prepared by this entity's teams. This entity could be located in Frankfurt in order to be "physically" close to the ESCB's headquarters. See *above*

If an agreement cannot be reached within the European Union Council, such an authority should be set up within the eurozone as a minimum.

³ Transparency is more specifically required for regulators to measure the effective size of these markets, the level of liquidity and volatility of their instruments, and to spot possible systemic positions taken up by players or types of players

⁴ See Eurofi document « Improving banking and insurance supervision at EU level through a EU network of supervisors »

THE EUROPEAN MACRO-PRUDENTIAL SUPERVISION INSTITUTION (EMPS)

CROSS FINANCIAL SECTOR MACRO SUPERVISION BOARD

EMPS Chairman

Member States (one representative each)

SEBC members

EC (one representative)

CEBS, CEIOPS, CESR (one representative each)

FINANCIAL SECTOR MACRO SUPERVISION BOARDS

- EMPS Chairman	- EMPS Chairman	- EMPS Chairman
- CEBS members	- CEIOPS members	- CESR members
- SEBC members	- EC (one representative)	- SEBC and EC (one representative each)
- EC (one representative)		

- Centralizing sector analyses and leading inter sector analyses
- Identifying and preparing recommendations for the National or European supervisory authorities and Central Banks, including related impact analyses (monetary policy, general or specific (assets, type of players) solvency requirements...)
- Identifying the regulatory or legislative provisions that the Level IIIs or other EC institutions must implement
- Liaising with the equivalent international bodies that are in charge of global financial stability
- Drawing up an annual report for the EC Institutions: macro-prudential situation, recommendations and reporting on progress on the consistency of their implementation.

Breakdown of responsibilities

Specific mandates

Changes to the mandate of European and national central banks are not required insofar as the identification and fight against asset bubbles represents a form of combating inflation.

The mandates of the national supervisors, Level III committees and national and European central banks may need to be adjusted in order to lead macroprudential management and supervision.

First of all, it is necessary to supplement the supervisors' current mission to include assessing the prudential consequences of the strategic choices made by the various financial players. In addition, the supervisors grouped together

within the CEBS, CEIOPS and CESR must be assigned the mission to identify, at European level, the systemic impacts of changes in financial businesses and the consequences of the economic assumptions commonly used by financial institutions. These Committees should be provided with the powers and resources required for such analyses and should be able to determine their consequences in terms of prudential requirements.

Responsibilities of the European Macroprudential Supervision Institution

This Institution's primary responsibility is to properly warn EU institutions and Member States if necessary. To avoid any inappropriate resistance from EU or national authorities, such warnings would have to be issued early and with full public disclosure.

All of its recommendations that relate to the monetary policy should of course be proposed to and implemented by the ESCB.

All of its recommendations that concern prudential requirements (countercyclical requirements) should be proposed to and implemented by EU supervisors using the possibilities provided by Pillar 2 of the Capital Requirement Directive (CRD).

All of its recommendations requiring legislative provisions should be proposed to and implemented by the existing European bodies in accordance with their usual mandates and operating methods (Commission, Parliament, Council, comitology).

Macroprudential supervision at global level

At global level, the Financial Stability Forum, created by the members of the G7 within the BIS in 1999, has a mission to assess the risks and vulnerabilities affecting the international financial system. Since its structure can be expanded, notably to include the main emerging countries and the representative from the European institution in charge of macroprudential supervision, it represents the global entity that is best positioned to pursue the analysis and recommendations on a global level.

However, it must be made public in order to avoid the usual resistance that political authorities are characterised by during a period of apparent calm. Similarly, it now seems necessary for the organisation grouping together finance ministers from IMF member states – the International Monetary and Financial Committee (IMFC) – to have decision-making powers enabling it to ensure the implementation of the measures, notably prudential, proposed by the FSF. The FSF would then be tasked to oversee their implementation.

This series of measures does not seem to require any amendments to international treaties.