European financial stability management, regulation, and supervision: Response by Liba, SIFMA, and ISDA to the European Commission’s call for comments on its “Driving European Recovery” Communication and the de Larosière Report

A. Summary

This paper comments on both: the European Commission Communication for the Spring European Council: “Driving European Recovery”, 4.3.2009 (“EC”); and the Report of the de Larosière Group, 25.2.2009 (“deL”). They need to be considered together, since EC endorses much of the detail of deL. We recommend below a number of refinements of the proposals in EC and deL in order to optimise the quality and coordination of EU financial stability and supervision.

EC and deL contain many elements we welcome and support, particularly the focus on improving the quality of regulation, supervision, and financial stability management, based on international standard setting and coordination. But there are some points, or areas where EC and deL are silent, that will need to be more carefully considered to ensure EU arrangements are well adapted, materially strengthen the EU financial system and economy, and do not give rise to additional risk.

We support the idea of a European Systemic Risk Council (ESRC), and highlight the need for it to interact effectively with global systemic risk analysis arrangements as agreed by the London Summit. But to be fully effective the ESRC needs more balance between supervisors and central banks, and between the authorities overseeing banking, securities and insurance. It also needs an appropriate mechanism for translating its assessments into action.

Regarding the proposed European System of Financial Supervisors (ESFS) we strongly endorse the essential need to improve the quality of supervision and international coordination, within the EU and beyond, again, taking account of the London Summit agreement. Standards of practice and quality of cooperation must be raised. This is the only foundation on which the proposed ESFS can be successful. We therefore strongly support deL’s Stage 1 of the ESFS, which fits well with work in progress under ECO FIN road maps, and with current improvements to Level 3 arrangements, including majority decision-making with safeguards and flexible college arrangements. Stage 1 should be pursued as a matter of urgency.

We think that more clarity and precision is needed about how new arrangements in Stage 2 of the ESFS would work, to enable well-grounded decisions to be taken about how the quality of any new EU authorities would be guaranteed, the relative decision-making powers of EU and national authorities, what adjustments are envisaged to EU legislative procedure, and the relationship between
We agree with deL that we need to be confident about improved and consistent supervisory standards before we can move to Stage 2 of the ESFS. The current state of progress on convergence of supervisory practice at Level 3 does not correspond to the successful completion of Stage 1. Much work therefore needs to be done, both to fulfil Stage 1 and to determine the characteristics of Stage 2, and we should not, as EC proposes, move straight to Stage 2. The decision whether to move to Stage 2 should not be pre-judged or scheduled at a fixed date now. It should depend on the outcome of a future review of progress made in Stage 1. Precise criteria for Stage 1 need to be set. Any reallocation of decision-making powers should be contingent on success in meeting those Stage 1 criteria, consensus on Stage 2, and resolution of fiscal responsibilities.

In section B below, we set out our views on the critical steps that would need to be taken before it could be judged whether a move to Stage 2 was appropriate, and the defining characteristics that any Stage 2 EU authority would need to have.
B. Criteria and defining characteristics for any move to Stage 2

The critical steps that we think need to be taken before a move to Stage 2, some of which are included in EC’s and deL’s proposals, are important objectives in their own right to make the EU regulatory system work better. They are therefore important elements of Stage 1, and should be pursued as a matter of urgency.

- Policy objectives: Global and EU agreement of defined public policy outcomes that regulation aims to achieve.
- Staff quality: Regulatory staff with the right skill sets and detailed knowledge and understanding of different markets. This is important for all markets, including retail, wholesale and corporate markets, but particularly for effective regulation and supervision of wholesale markets.
- Colleges: Ensure that colleges established under EU arrangements are consistent with, and interact smoothly and seamlessly with international colleges, on the basis of globally agreed guidelines. Ensure they can work flexibly, to enable key supervisors to discuss strategy and all relevant authorities to exchange information and coordinate supervision, accommodating third country and EU supervisory authorities as appropriate.
- Legislative implementation: Full and consistent implementation of the harmonised core rules in EU legislation by Member States, enforced under Lamfalussy Level 4.
- Supervisory convergence and flexibility: Analysis of what degree of convergence is appropriate in different supervisory tasks, and how far supervisory flexibility is valid or necessary, recognising that the optimal level of integration may need to differ in different areas.
- Fiscal issues: Resolution of fiscal support issues in a way that ensures alignment between regulatory / supervisory decision-making and fiscal / lender of last resort responsibility.

These criteria having been met, we think the following would need to be the defining characteristics of any EU authority to ensure that it was of the highest quality. They would need to be clearly established, in the constitution and working procedures of the EU authority, at the outset.

- Governance: Explicit attention to the wholesale and global character of cross-border markets; ensure that all those who are interested in what the authority does can have their voice heard; specification of who it is answerable to; specification in advance of how the quality of its performance will be measured, and what sanctions will be available if it fails.
- Scope: Clear demarcation of boundaries of competence between the EU authority and national authorities, in particular as regards: scope for differential implementation of an agreed regulatory outcome; national autonomy over supervisory approaches, technical decisions, and issues not harmonised at EU level, use of comply or explain procedures. This demarcation needs to dovetail with fiscal responsibility.
- Regulatory philosophy: Outcome-focused regulatory approach, based on agreed public policy needs.
- Regulatory process: Effective regulation disciplines, including market failure analysis, impact analysis, and cost-benefit analysis, diligent consultation, and
genuine dialogue with regulated entities and other interested parties, as standard procedure.

- Quality of staffing: Technically expert and market-aware governing council and staff; alert and rapidly responsive to market developments.
- Quality control: Analogous to Level 4 (with EC cooperation where necessary) to achieve consistent effective implementation of EU legislation.
- Differentiated regulation: Explicit acknowledgement of, and attention to, different needs of different markets and sectors: banking / securities and derivatives / infrastructure / insurance; wholesale / retail; different supervisory tasks: prudential (various) / conduct of business / market; in each case, specification of what is the scope of the EU authority’s / authorities’ responsibility (which might differ from one sector or task to another).
- Location: Proximate to the EU’s key global markets, so that it can have close interaction and dialogue with them, and draw on strong pools of technical talent.

Any Stage 2 EU authority would need to have characteristics along these lines if any transformation of this sort, involving significant transfer of powers from national level were to be contemplated. Any shortfall in these areas would necessitate either a deferral of decisions on Stage 2 until the necessary improvements had been made, or changes to the reallocation of powers.
C. Comments on detailed aspects of EC (References are to the numbering in EC. We comment on sections 2 and 5):

2. Restoring and Maintaining a stable and reliable financial system

EC proposes five objectives, of which we comment on (1), (2), (4), and (5):

(1) A financial supervision package (May 2009), to be followed by legislation in autumn 2009, to establish:

European body to oversee the financial system as a whole.

del’s ESRC proposal offers a good basis for gathering and analysing macroprudential information and issuing warnings. del’s stress on the link between the ESRC and global arrangements for financial stability analysis and decision-making as agreed at the London Summit is an essential element. del’s ESRC could be an improvement on BSC, but to be so, it needs a better balance of representation and communication. In particular, unlike the BSC, del’s recommendation relies heavily on central banking participants. With the chairmanship and secretariat provided by the ECB, the ESRC’s risk analysis could be too strongly focused on a commercial banking paradigm. The only supervisory involvement, or representation of securities markets or insurance supervisors, is proposed to be through Level 3 Chairs and alternates to central banks. Better arrangements for macroprudential cooperation need more balanced involvement of supervisors, so that the risk analysis can take account of the supervisors’ information, and to improve the transmission of risk analysis into actions by supervisors. There also needs to be more balanced involvement of securities and insurance supervisors, to ensure appropriate focus on securities and derivatives markets and insurance issues, as well as commercial banking issues, in the analysis. And there needs to be an effective mechanism for pursuing action, either within the EU or at global level, in response to the ESRC’s assessments: a comply or explain mechanism for doing this could be explored.

European financial supervision system

EC differs from del’s proposal in two important respects:

(a) EC proposes to dispense with del’s Stage 1, and to move straight to Stage 2, so that the ESFS would be in place by 2010.

(b) Although it says that it will build on del, EC is vaguer than del about precisely how the ESFS would operate. For example, EC is more cautious on the review of sanctioning regimes, and does not refer to the mandatory decision-making powers that del envisaged for the proposed EU authorities, referring instead to things that the ESFS "could" be charged with.

Thus EC proposes moving faster than del to set up the ESFS, but with less clarity about the objectives of the ESFS, or what it would look like.

The improvement of EU supervision and supervisory cooperation arrangements needs to be careful and considered, and take account of developments in other
jurisdictions as the London Summit action plan is developed. Institutional changes will not affect the resolution of the current crisis, so they should not be treated as an urgent crisis response. Furthermore, the lessons of the market turmoil need to be fully absorbed, so that new EU arrangements are well adapted to avert or manage future market turmoil in the next cycle.

In order to make well-grounded decisions, it will be crucial to be clear on the answers to important questions that EC and deL do not tackle in detail, among the most important of which are the following. We suggest how they should be resolved above in our suggested criteria and defining characteristics for any move to Stage 2.

- Neither deL nor EC addresses the relationship between decision-making power and fiscal responsibility. Under deL’s proposals, in many cases, EU-level decision-makers would not be accountable to national fiscal authorities. If risk is to be managed effectively, there can be no mismatch between those who take decisions, and those who are responsible if the decision is wrong. It is important to resolve this issue for well-managed decisions to be taken.

- deL rightly emphasises the importance of subsidiarity, proportionality, and accountability, but proposes a ESFS that could involve important shifts of powers from Member States to EU institutions, affecting the supervision of all firms, in particular cross-border firms. EC is vaguer than deL about the balance of subsidiarity, proportionality, and accountability. It is important to be clear what balance is proposed, so that well-grounded decisions can be made. deL proposes that the new EU authorities would be able to impose binding supervisory standards by QMV, apparently without the existing “comply or explain” safeguard. Sanctioning supervisors for failure to comply with EU authorities’ binding supervisory standards (as proposed by deL through fines, infraction proceedings, or takeover of national supervisors’ powers) might not be compatible with high-quality regulation, and might increase risk rather than control it. Rather than assuming that in all cases imposing the qualified majority view will be optimal, it will be important to analyse the best outcome in particular cases, to ensure that generic supervision is not applied in cases where the local need calls for more sensitivity. For example, consistency of supervisory reporting standards and formats is intrinsically desirable and straightforward to identify. However, in areas requiring skilled supervisory judgement it is not clear that it would be possible for a QMV approach, which would necessarily be at one remove, to respond to local conditions and requirements, even if we were confident that all supervisors concerned had the requisite high-level skill set for QMV decision-making to work effectively and acceptably.

- deL proposes that the new EU authorities would impose “binding mediation” of disputes between national supervisors, and binding technical decisions - e.g. on model approval, add-ons, licence withdrawal, legal interpretation - on particular firms, overriding national supervisors. The intention of deL’s proposed binding standards and “binding mediation” seems to be to try to provide ‘teeth’ to peer review, but any proposal for the ESFS needs to be clear about where national authorities can legitimately apply different
supervisory approaches. Lack of such discretion could impair the quality of supervision, if the decisions imposed were not well adapted to local conditions.

- deL and EC use the word 'college' with different contexts and meanings in the ESFS and the proposals for global cooperation (see comments under 5 below). In the ESFS context, deL and EC imply a different concept from global colleges. These EU “colleges” would be a highly structured interaction based on the consolidating supervisor concept, with the participation or role of non-EU supervisory authorities not addressed. EC’s and deL’s description of “global colleges” is consistent with international usage: the cooperative structure facilitating the exchange of information and coordination between supervisors who do not share a common legal framework, and which the London Summit confirmed as the basis for global supervisory cooperation, under the guidance of the FSB. It is clearly valid to use EU legislation to align EU requirements and give responsibilities and tasks to the consolidating supervisor of the parent EU entity. Equally, however, to be effective college arrangements need to take account of the non-EU dimension. It would be duplicative, inefficient, and risky to seek to force EU and global colleges to operate separately. Binding EU requirements cannot, by definition, apply to non-EU authorities, so it is difficult in practice to envisage how direct EU oversight of and intervention in global colleges, as deL envisages, could be compatible with international cooperation. It is important to be clear about the differences between the two uses of the word ‘college’, eliminate the scope for duplication and conflict between them, and avoid the consequent increase in risk.

- Neither deL nor EC considers how the proposed ESFS would ensure that the rules and decisions that it generated would be properly risk-based, outcome-focused, and grounded on proper analysis of impact. An essential part of the improvement of the quality of regulation as part of Phase 1 will be to embed in the EU process routine disciplines to safeguard the technical quality of EU-level proposals. It will also be important to review EU rules which are currently in place or under development to ensure that they are consistent with the revised framework of standards currently being developed by international standard-setters.

deL envisages a third stage in which the powers of the proposed new EU authorities might be increased, and they might be reduced from three sectoral authorities to two authorities dealing with prudential and conduct of business / market issues. The UK proposes instead to work towards amalgamating all three Level 3 Committees into a single body, independent of the Commission, which would have a stronger role in rule-making, reducing national differences, and peer review, and would be accountable to the Council. The UK stresses the need for alignment of supervisory with crisis management and fiscal responsibility, and proposes that the new authority would not prescribe detailed supervisory practices or be able to override national supervisory decisions. While these issues are important, the UK also implies important changes in the allocation of powers in rule-making whose uncertainties and implications would, like those in EC and deL, need to be carefully examined and resolved as we suggest above.
(2) Regulatory policy proposals

- Legislation on hedge funds, private equity, and other systemically important players (April 2009)
- White Paper on tools for early intervention (June 2009)
- Initiatives to improve transparency and stability regarding derivatives
- Legislation on prudential capital relating to trading book and complex securitisation (June 2009); and liquidity risk and excessive leverage (autumn 2009)
- Plan of action to establish more consistent rules (2009)

In many ways EC’s proposals reflect initiatives already in train in other contexts, in particular the FSF Action Plan, and the policy programme agreed by the London Summit, which will be carried forward by the FSB. In many areas the work is already well under way or close to completion. For example, the improvements to Basel II to strengthen trading book capital, and the treatment of securitisations and re-securitisations. Liquidity and leverage are also the subject of current Basel Committee consultations or work programmes. Especially now that the Commission is a member of the FSB, it is important that in all these cases Commission proposals reflect, and are timed to be able to take into account, the global consensus and the outcome of initiatives by international standard setters.

del proposes the ‘simplification and standardisation of OTC derivatives’. OTC derivatives, properly managed, are a crucial means to control risk. While it is important to ensure that the infrastructure of OTC derivatives is properly controlled, it is also important to ensure that the authorities do not dictate or limit the design of OTC derivatives in ways that could exacerbate risk or inhibit responsible risk taking, for example, by limiting the availability and/or increasing the cost of instruments used to hedge risks.

Clearing of CDS is already happening, with US$70 billion of notional processed at the time of writing and the amount rising rapidly. This builds on the 80%-plus reduction in counterparty exposure achieved through bilateral close-out netting and collateralisation (themselves ensured through industry standard documentation). The addition of central clearing has occurred as a result of voluntary industry initiatives (following those already developed for interest rate swaps) once the market reached a point where clearing became viable.

It is also worth pointing out that contractual standardisation has been a key part of the mission of the International Swaps and Derivatives Association since its inception. ISDA has been working intensively to support economic standardisation in the credit default swaps market in recent years, and this work will facilitate the commitment of leading dealers in the market to embrace central clearing of their own CDS trades in clearing houses in both Europe and US. This work stream will harmonise cash settlement procedures in CDS contracts1 when a default occurs, as

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1 The ISDA cash settlement mechanism employs an auction-style process to establish a clear common cash settlement price once a credit event has occurred. This approach has now been ‘hardwired’ into CDS contracts. It had already been used many times before the Lehman Bros default for other credit events, and successfully coped with the Lehman default: $72 billion of assets deliverable ‘notionally’
well as introducing a common procedure for determination of what constitutes a
credit event. We remind the Commission that leading dealers have committed to
using a global central counterparty for CDS for a long time, and the recent
commitment to use a European CCP signals major dealers’ recognition of EU
regulators’ concerns.

We would also add that the reference in paragraph 27 of deL to credit derivatives
having ‘played a significant role in triggering' the crisis suggests a slightly skewed
emphasis. Much has been written about the causes and consequences of the events
in the financial markets over the last twelve to twenty-four months, most of which
concentrates on the events in the US housing market during 2007, which caused
ripple effects in a multitude of financial markets that we are still experiencing today.
Although derivatives have played a part in this process, as might be expected given
there are active derivative markets across virtually all product classes, it may not be
entirely accurate to suggest that they triggered the crisis. Losses in derivative
markets were a symptom of, more than a trigger for, the financial turmoil.

EC’s proposal for a plan to establish more consistent rules reflects deL’s Stage 1 call
for a determined effort to eliminate national options in EU legislation. This is
sensible in many contexts (but not in others, as deL recognises). It is an effort that
has been going on for some time, and needs renewed impetus as part of Stage 1.

(4) Measures on risk management and pay incentives:

- Review of 2004 EC Recommendation on director remuneration (April 2009)
- Recommendation and legislation on financial services remuneration (April/autumn
  2009)

As in the case of EC’s objective (2) above, these proposals reflect initiatives which
are already in train in other contexts, as confirmed by the London Summit. It is
similarly important that they align and coordinate with global initiatives.

(5) Measures to ensure effective sanctions against wrongdoing:

- Review of Market Abuse Directive (autumn 2009)
- Proposals on strengthened harmonisation of sanctions (autumn 2009)

EC and deL’s Stage 1 calls for alignment of supervisory powers and sanctions. This is
a programme of work that has been suggested previously, is sensible in many
contexts, and needs renewed impetus.

5. Promoting global recovery: the European contribution to the G-20
Summit

EC proposes:

were processed with only $5.2 billion of assets ultimately ever having to be transferred. The fears
about how Lehman Bros CDS trades would be unwound were founded on a misunderstanding by
commentators: whereas in fact ISDA had already developed procedures to deal with this eventuality.
o **Improving transparency and accountability**: improve banking prudential rules and accounting standards by building in counter-cyclical mechanisms and addressing fair value; capital requirements to reflect liquidity risks and realign incentives on securitisation; improve IASB governance structures.

o **Enhancing sound regulation**: extend regulation and supervision, particularly Basel standards, to hedge funds, private equity, non-regulated credit institutions; measures on quality, transparency, and conflicts regarding credit ratings; remuneration policies avoiding short-term excessive risk-taking and subject to supervision.

o **Promoting integrity in financial markets**: list of uncooperative jurisdictions and measures for use against them regarding supervision, anti-money-laundering, anti-terrorist-financing, taxation; increased prudential and transparency requirements relating to off-shore centres; harmonise rules on holding and transferring intermediated securities.

o **Strengthening international supervisory cooperation**: global colleges; exchange of good practice; convergence of supervisory practices.

In all these respects, EC is right to propose that the EU takes a leading role in global policy development. But the EU should not seek unilaterally to pre-empt global policy. Particularly now that the Commission is a member of the FSB, the EU needs to work towards global consensus, and in doing so, commit to implementing the global consensus. Where the EU has already put in place legislation, or is in the process of doing so, ahead of the global consensus, it will be important to review EU measures once global agreement is reached, to ensure that EU measures are consistent with it.

The trans-Atlantic dialogue has a crucial role to play in this and other respects. We highlight the importance of explicit attention and commitment to making EU/US convergence work.

We welcome the support for international colleges. As explained above, it is important to note that the both EC and deL use the same term (“colleges”) both in the context of international colleges, where they use the common meaning - a grouping of supervisors exchanging information and possibly agreeing coordination - and when they refer to EU “colleges”. In the EU context a different concept is intended - that of a highly structured interaction based on the consolidated supervisor concept. It is important to be clear about the differences between the two concepts, the scope for duplication and conflict between them, and how such duplication and conflict is to be avoided. To be effective, EU policy must focus on treating global colleges, under the aegis of the FSB as agreed by the London Summit, as the prime forum for international supervisory cooperation, separately from the use of EU legislation and supervisory coordination to align supervisory practice in the EU sub-group.

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