



EUROPE'S REGULATORY REFORM AFTER THE CRISIS—A
MACROPRUDENTIAL PERSPECTIVE

*Marta Božina Beroš, M.Phil.*¹

I. INTRODUCTION

The recent economic and financial crisis has highlighted the need for significant changes to European financial regulation and its regulatory counterpart: supervision. Significant build-ups of leverage and liquidity mismatches accumulated across national financial systems that preceded the crisis left the European financial system highly vulnerable to adverse changes in the market environment and sowed the seeds of the present macroeconomic and regulatory problems.² Consequently, the inefficiency of the traditional microprudential level of regulation to safeguard the soundness of the financial system as a whole has become more than evident. At the same time, the crisis prompted the old coordination/centralization debate regarding supervision. Against this background, consensus has been growing that the founding principles as well as the efficiency and effectiveness of E.U. financial regulation and supervision need to be reassessed.³

The recommendations of the 2009 de Larosière Report⁴ were a significant step towards a different regulatory future for the European Union and its Member States. In particular, the proposed reform of the European supervisory structure was one of the most anticipated, and lately often debated, reforms introduced by the Report.⁵ This Article briefly analyses both the premise that macroprudential policy was an important missing policy pillar for the past decade and the current decisive shift of European regulatory policy towards a macroprudential approach, institutionally represented by the European Systemic Risk Board. The general task of this body is to “form judgements and make recommendations on macroprudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give directions on these issues.”⁶ The Article concludes that only arrangements that acknowledge the complex interdependence between the micro and macroprudential level can strengthen the European regulatory and supervisory framework and sustain overall financial stability.

¹ PhD candidate at the Faculty of Economics University of Ljubljana and Teaching and Research Assistant at the Faculty of Economics University of J. Dobrila in Pula.

² BANK OF ENGLAND, THE ROLE OF MACROPRUDENTIAL POLICY: A DISCUSSION PAPER (2009).

³ Donato Masciandaro, Maria J. Nieto & Marc Quintyn, *Will They Sing the Same Tune? Measuring Convergence in the New European System of Financial Supervisors*, 37 CEPR POLY INSIGHT 1 (2009).

⁴ The High-Level Group on Financial Supervision in the E.U., *De Larosière Report* (Feb. 25, 2009) [hereinafter *De Larosière Report*].

⁵ This reform was adopted by ECOFIN on June 9, 2009, and by the European Council on June 18–19, 2009.

⁶ *De Larosière Report*, *supra* note 4, ¶ 177.

II. PRINCIPLES OF MACROPRUDENTIAL REGULATION

Financial regulation worldwide was based on the assumption that by making each financial institution safe the system as a whole was safer. Thus, the approach to financial regulation was dominantly microprudential. Microprudential regulation consists of such measures as the authorization of those working in the financial sector; rules on what assets can be held by whom; rules on how financial instruments are listed, traded, sold, or reported; and finally rules concerning capital adequacy requirements which measure the riskiness and value of the assets.⁷ As such, microprudential regulation was concerned with the stability of individual entities neglecting endogenous risks and the systemic implications of common behavior.

However, in the aftermath of the 2007–08 global economic and financial crisis, the issue of reducing risks to the system as a whole has emerged as a European policy priority. A macroprudential approach to regulation considers the systemic implications of the collective behavior of financial institutions. A characteristic feature of the macroprudential approach to systemic stability is the acknowledgment of the system’s heterogeneity. Homogenous behavior that was witnessed within the banking sector during the crisis—when banks were selling similar toxic assets at the same time, causing their prices to collapse and making banks short of capital and resulting in a “loss spiral”—undermines the system. It seems market participants start off as heterogeneous but certain regulatory characteristics drive them to homogeneity. Consequently, we may conclude that systemic risk is endogenous and that the task of macroprudential regulation should be to identify those endogenous processes that turn heterogeneity to homogeneity, challenging the financial system’s resilience.

A macroprudential policy is one that focuses on the financial system as a whole and treats aggregate risk as endogenous with regard to the collective behavior of institutions.⁸ In the broadest sense, the main policy objective of macroprudential regulation is ensuring the resilience of the financial system over time, protecting financial institutions from the negative effects of the economic cycle. Macroprudential rules should seek to avoid the “boom and bust” cycles in the supply of credit and liquidity that have marked the recent crisis. During economic upswing, the objective of dampening the credit cycle is usually well aligned with the objective of making the financial system more resilient. By tightening capital requirements in an upswing, regulators would encourage financial institutions to monitor growth in their balance sheets, which would support financial resilience and reinforce the wider macroeconomic objective of credit supply and its cost. A macroprudential policy assumes that conservative lending in times of financial duress (as mandated by microprudential regulation) is counterproductive as it results in weakened economic activity and excessive loan defaults. Following a macroprudential approach during an economic downturn, when credit and asset prices collapse a continuing flow of lending would be

⁷ THE SECOND WARWICK COMMISSION ON INTERNATIONAL FINANCIAL REFORM, IN PRAISE OF UNLEVEL PLAYING FIELDS 12 (2009).

⁸ E. Phillip Davis & Dilruba Karim, Keynote Address at the 6th Euroframe Conference on Economic Policy Issues in the European Union: Macroprudential Regulation—The Missing Policy Pillar (Jun. 12, 2009).

ensured by allowing buffers of regulatory capital accumulated during the “good times” to be drawn down.⁹

The main functions of a European macroprudential framework include:

- (1) the identifications and assessment of risks and vulnerabilities in the European financial system;
- (2) the issuance of early risk warnings;
- (3) the adoption of related recommendations on macroprudential policies.

The interconnectedness of financial institutions and markets within the European Union implies that the due monitoring and assessment of the implementation of macroprudential policy should be based on relevant macro-economic and macro-financial data, as well as information provided by microprudential supervisors and information obtained from market intelligence.¹⁰ This information and data gathering is especially important from the view of macroprudential policy limitations.¹¹

III. THE EUROPEAN SYSTEMIC RISK BOARD

After the consensus of European policymakers that the de Larosière Report indeed represented the basis for prospective reform, in March 2009 both the European Commission and the Council endorsed the recommendations of the Report on the future design of the European regulatory and supervisory structure. In May 2009, the Commission published a Communication on Financial Supervision in the E.U., describing the institutional and other technical details of the Recommendation's implementing process.¹² The Communication gives special consideration to the establishment of two new bodies: the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS), but more importantly, it signals a clear shift towards macroprudential regulation within the Union. The communication was swiftly followed by the Commission's legislative proposals.

The ESRB represents a central building block of the future European supervisory structure which monitors and assesses potential stability risks arising from market developments that may have adverse impacts on a sectoral level or on financial stability overall. As the Commission has stated in its legislative proposals, the ESRB represents an entirely new European body established on the basis of Art. 95 of the E.C. Treaty.¹³ It is a body without legal personality responsible for the

⁹ This is in sharp contrast to microprudential regulation where policymakers are concerned only with the safety and soundness of individual financial institutions and traditionally impose conservative lending policies. *See* BANK OF ENGLAND, THE ROLE OF MACROPRUDENTIAL POLICY, *supra* note 2.

¹⁰ Lucas Papademos, Address at “After the Storm: The Future Face of Europe's Financial System”: Strengthening Macro-Prudential Supervision in Europe (Mar. 24, 2009).

¹¹ Macroprudential instruments can moderately temper the credit cycle as free capital mobility and cross-border lending pose significant challenges to the possibility of tightly controlling the overall expansion of domestic credit.

¹² Commission Staff Working Document Accompanying the Commission Communication: “European Financial Supervision”—Impact Assessment, SEC (2009) xxx (Feb. 21, 2010).

¹³ *Commission Proposal for a Regulation on Community Macroprudential Oversight of the Financial System and Establishing a European Systemic Risk Board*, at 3, COM (2009) 499 final (Sept. 23, 2009).

macroprudential oversight of the European financial system. Given the wide scope and the amplitude of its mission, it was decided that the ESRB shouldn't be granted legal personality and binding powers but rather conceived as a body which draws its legitimacy from its professional reputation for opinionated views, independent judgments, high quality analysis, and objectiveness of its conclusions. The ESRB shall be set up with the administrative, analytical, statistical, and logistical support of the European Central Bank (upon which specific prudential tasks are conferred for the first time), which will also bear its budgetary costs. In addition, an overall high percentage of central-bankers' involvement is envisaged in the ESRB.¹⁴ Without going into further technical details regarding the structure, organization, and political accountability of the ESRB, we will briefly focus on its regulatory objectives from a macroprudential perspective.

The ESRB lays the conditions for an improvement of the risk monitoring quality at the supranational level through a newly defined allocation of responsibility. It closes the existing supervisory gap by ensuring a new mechanism for translating early risk warnings into policy actions. The ESRB is conceived as a "reputational body" whose decisions and opinions should influence the actions of policymakers and supervisors by means of its moral authority. It is intended to issue risk warnings and recommendations which identify potential imbalances in the European financial system which are likely to have systemic effects. If such risk is identified, the first action taken by the ESRB would be to issue warnings that should prompt early responses in order to avoid the accumulation of wider problems. If the situation is deemed particularly relevant for systemic stability, the ESRB may issue recommendations that have to be transmitted to the Council. These instruments are not legally binding. However, it is expected that the addressees of these recommendations will act accordingly and report on the preventive actions taken to the ESRB.¹⁵ In order to guarantee that corrective action will be taken by the addressees, the ESRB may decide to publicize its opinions. It is worth noting that the ESRB will also provide technical advice on issues of E.U. prudential framework from a systemic perspective, which basically means that systemically relevant E.U. financial institutions should be identified.

Finally, the ESRB will contribute significantly to the further development of the macroprudential approach to E.U. regulation. This implies close cooperation with the ESFS. In addition, the new body will probably act as a valuable counterpart to other international financial institutions as regards open issues of macroprudential regulation.

IV. CONCLUSIONS

Both the de Larosière Report and the Commission's legislative proposals have finally drawn attention to a neglected fact—that every financial system is, in fact, a *system*. The European one is characterized by financial institutions that may be deemed "too big to fail," too interconnected and complex to be regulated, and supervised from only a microprudential level. In such circumstances it is important to structure a macroprudential regime that will ensure transparency, accountability, and some predictability. Macroprudential issues are clearly different from the microprudential ones; they refer to interdependencies and endogeneities in the system which lead

¹⁴ *Id.* at 4.

¹⁵ The addressees may be the Community, Member States, one of the European Supervisory Agencies that form the ESFS, or one of the national supervisors.

individual institutions to act homogenously. As briefly outlined in this Article, the macroprudential approach to financial resilience would ensure heterogeneity of business views and behavior.

Europe's first step towards better macroprudential oversight is symbolized by the formation of the ESRB. The creation of the ESRB is part of the package of regulatory and supervisory reforms proposed by the European Commission following the de Larosière Report which clearly signals a shift towards macroprudential regulatory policy in line with global regulatory trends. Although the current proposal for the institutional set up, organization, objectives, and accountability of the ESRB is subject to voiced criticism,¹⁶ this shouldn't diminish the value of Europe's policy efforts to take affirmative action. However, there is a danger that too much reliance will be placed solely on the ESRB and consequently on the central banks to ensure that regulatory failure does not happen again.

¹⁶ See, e.g., Willem Buiter, *The Proposed European Systemic Risk Board is Overweight Central Bankers*, FIN. TIMES BLOG, Oct. 28, 2009, <http://blogs.ft.com/maverecon/2009/10/the-proposed-european-systemic-risk-board-is-overweight-central-bankers/> (last visited March 24, 2010).