

EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

STATEMENT No. 2

19 October 1998

EMU, THE ECB AND FINANCIAL SUPERVISION

In this statement, we recommend that:

1. The twin principles of home country supervision and mutual recognition should be supplemented in the short run by a clear allocation of responsibilities in times of crisis, and a mechanism to ensure that all financial institutions operating in Europe have an effective lead supervisory authority;
2. Looking ahead, we foresee the need for a European-wide structure for monitoring systemic risk;
3. Finally, while the lender-of-last-resort function should be used with restraint, the present ambiguity regarding the allocation of lender-of-last-resort responsibilities as between the ECB and national central banks needs to be resolved.

The recent market turmoil has brought the discussion of financial supervision to the forefront. Within a European context, monetary union is prompting a quantum leap in interpenetration of financial institutions and markets. These developments generate a new potential for European-wide instability while also reducing the capacity of individual member states to handle crises. Against this background, it is necessary to reassess the adequacy of home country control and existing provisions for the lender-of-last-resort.

The ECB will have independent powers to maintain price stability, but financial stability and prudential control will remain in the hands of national authorities. The European Shadow Financial Regulatory Committee (ESFRC) believes that this framework contains potential risks that would be alleviated by the above recommendations.

1. Supervision and crisis management

At present supervisory coordination is based on bilateral memoranda of understanding. However, closer market integration under EMU demands intensified cooperation between supervisors and central banks both at national and European levels. It is important that such cooperation be underpinned by a clear EU-wide agreement on a code of conduct covering supervisory responsibilities and standards in order to avoid misunderstandings, institutional rivalry, and

excessive forbearance by national supervisors. The overriding objective would be to ensure that all banks, financial conglomerates and other financial institutions are adequately supervised by a lead regulator. The ECB could in this context act as a clearing house for cooperation agreements between national supervisors at EU and international levels. The coordinating mechanism should in particular make provision for the allocation of responsibilities in times of crisis. Such coordination at the European level would represent a contribution to global financial stability.

2. Towards a European-wide structure

As the euro-capital market deepens and pan-European financial groups become dominant, the cooperative mechanisms will have to be supplemented by a European-wide structure. This reflects the fact that any supervisory shortcomings in a particular jurisdiction would be quickly felt in other member states. The new structure could take the form of a European Observatory of Systemic Risk which might or might not be a part of the ECB. The aim would be to ensure common supervisory and transparency standards, to monitor market developments across Europe and alert national and European authorities to exposures with a potential systemic impact. This does not imply that the new entity is given decision-making power, but it must be in position to obtain information from national authorities.

3. Align lender-of-last-resort operations in EMU

It is remarkable that in a complex new financial structure embracing the ECB and eleven national central banks, nothing has been publicly stated to reduce the ambiguity contained in the EU Treaty about lender-of-last-resort (LOLR) operations. This ambiguity should be eliminated. In our previous statement (22 June 1998), we outlined procedures for early intervention that would minimise the need for a LOLR assistance to problem banks. Nevertheless, financial stability may at times require the existence of a smoothly functioning LOLR.

The capacity of national central banks to provide liquidity to local institutions is potentially in conflict with the ECB's responsibility for determining liquidity at EMU level. Any operation that is undertaken on the national level has EMU-wide monetary repercussions. For example, an interest rate subsidy to a local problem bank may in the end be paid for by other banks in the EMU and their customers. For these reasons, and on the grounds of competitive equality, procedures for LOLR operations should be harmonised and responsibility for emergency liquidity provision should be clearly allocated between the ECB and national central banks. The procedures should require adequate collateral, penal interest rates and, above all, prior authorisation from the ECB for the injection of liquidity at local level.