Features

European Supranational Financial Supervision: A System Forged in Crisis

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Dr. Christopher P. Buttigieg, the chief officer responsible for Supervision at the Malta Financial Services Authority, shares some thoughts about how financial crises have shaped the European System of Financial Supervision.

International and Regional Regulatory Institutions (IRIs) have, throughout history, been created and reshaped by crises. This article argues that this phenomenon can be explained through rational choice neo-institutionalism, which argues that crises shift policy equilibrium and allow for greater political will towards solving the root causes of the crisis – in turn, this usually involves some degree of power delegation from the national to the supranational. This article applies this theory to the creation and further development of the European System of Financial Supervision (ESFS) in two cases: (1) the post-2009 crisis; and (2) the post-sovereign debt crisis. The points in this article are derived from and attempt to summarise a paper on this subject co-authored with Beatriz Brunelli Zimmermann. (For more details on the paper, see note at end of article).

Inertia describes a situation in which an object remains in a particular state unless an external force comes into play. Interestingly, the process behind the creation and further development of institutions is similar to that of inertia: under a default setting, political arrangements tend to remain solid, until an external force with sufficient power comes into play – in the cases of institutions, this force can be a crisis.

The establishment of the ESFS – a European-level IRI in the area of financial supervision – has its roots in the 2009 global financial crisis. The ESFS is composed of a macro-prudential supervisor represented by the European Systemic Risk Board; three sectoral micro-prudential supervisors, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), jointly known as the European Supervisory Authorities (ESAs); and the National Competent Authorities (NCAs). The European Central Bank (ECB), in its role as banking supervisor in the Euro zone, also plays a role within the ESFS.

Pre-2009, European financial supervision was led by the argument that the EU's regulatory framework had failed to adapt to increasing market complexity and that the existing framework hindered the development of the single-EU financial market due to lack of cohesiveness. In order to mitigate such shortcomings, the Lamfalussy architecture was set up: it was a complex committee-based system, which placed the European Commission (EC) at the heart of the regulatory process, while the so-called level 3 committees – which were largely sector-based and micro-prudential – had the role of advising the EC and ensuring the coherent transposition and implementation of EU law at national law. Therefore, the level 3 committees had limited power, influence and were soft law based. Lamfalussy's architecture was, therefore, the financial institutional equilibrium pre-2009 in Europe: despite its shortcomings, the system was deemed an important contribution to greater harmonization of financial regulation and supervision. At the backdrop of the Lamfalussy's architecture, a crisis unfolded: the 2007-08 financial crisis, which had started with the collapse of the American housing market.

With the emergence of the 2009 financial crisis, Lamfalussy's architecture – which was largely based on decentralization and cooperation – quickly fell short, especially on the cooperation aspect. Indeed, the banks that had been impacted by the crisis were approached with national solvency-related solutions and, due to the micro-prudential nature of the architecture, financial stability matters were also dealt with at a national level with ad hoc cooperation arrangements. These practices were a sign of a lack of EU-wide convergence within the financial sector. Moreover, because the level 3 committees mostly had an advisory role, cooperation between Member States during crises management and resolution was largely voluntary and decentralized. As a result of this, systemic risks – such as the 2009 global financial crisis – lacked early identification and a cohesive response. Thus, in order for the EU Single Market to continue to thrive and to regain market confidence in the European financial system, a new approach had to be taken within financial supervision. At the time, the shortcomings of the Lamfalussy's architecture that were uncovered by the crisis, especially in the realm of cooperation, produced enough political will towards understanding the causes of the crisis and mitigating them.

It was at this backdrop that the EU High-Level group on Supervision was asked to prepare a report on the matter – known as the de Larosière Report. A few of the report's main findings were that the EU lacked a macro-prudential supervisor, supervisory cooperation and that the level 3 committees lacked hard law powers and resources. The proposed solution was the establishment of the ESFS, which recognized that regulatory coordination would need to be followed up by a strong institutional supervisory system. Institutionally speaking, this was followed by the set-up of the ESRB for macro-prudential supervision; three micro-prudential supervisors – the EBA, ESMA and EIOPA, collective known as the ESAs. Therefore, as intimated by rational choice neo-institutionalists, the crises shifted the policy equilibrium and generated the political will towards solving the root causes of the crisis – in turn, this involved power delegation from the national to the supranational.

Following the 2009 global financial crisis, European banks – particularly in small states, which largely relied on banking systems that were disproportionate to their size, – required an equally disproportionate state funding so as to avoid insolvency. In turn, the bad outlook for European banks and the public money spent to avoid insolvency decreased market confidence in government bonds and overall public confidence in banks. To the EU, the relevant takeaway of the chain of events described above was that the sovereign debt crisis was also a banking crisis and that there had to be a strong supervisory banking mechanism in place so as to avoid a future scenario in which banking crises could potentially spill over and become an EU-wide crisis due to the high potential for cross-border contagion resulting from the widespread use of the Euro. Moreover, another conclusion was that the crisis was exacerbated by the lack of supervisory and regulatory convergence between Member States, which had no agreement on banking resolution mechanisms and burden sharing. Therefore, the argument was that greater centralization had to be introduced in this regard.

The policy equilibrium had once again been shifted and the solution proposed towards addressing the identified weakness was that of achieving through the creation of the European Banking Union (EBU), which is comprised of the SSM and the Single Resolution Mechanism (SRM). While the former directly empowers the ECB to carry out direct supervision over systemically relevant banks – task which was previously the responsibility of the bank's NCAs – the latter introduced the Single Resolution Board (SRB), as the European authority responsible for discussing matters of resolution and insolvency of banks.

The introduction of the EBU, especially of the SSM, was yet another major delegation of power and institutional development: regulatory speaking, the acquired supervisory powers of the ECB were the product of gradual changes introduced by EU. These gradual changes, that implied some degree of loss of national power and sovereignty, were triggered in the post-sovereign debt crisis as a result of the acknowledgment that sovereign debt is intrinsically linked to the banking system.

The emergence of IRIs following the onset of a crisis can be explained through the theoretical lenses of rational choice institutionalist theory. This theory sets out three main incentives for the setting up of international institutions, namely coordination, trust and certainty and diminished transaction costs. However, these incentives come at a cost: that of delegation of power. In order for actors to benefit from the incentives that international institutions may offer, they need to delegate a portion of its power and, ultimately, sovereignty from the national to the supranational. When the benefits are considered to be greater than the cost of that delegation, then international institutions are set up and empowered accordingly. More specifically, crises are known to change the a priori equilibrium arrangements that entailed a balance between costs and benefits (i.e., institutional inertia) – following a crisis, actors will potentially be more willing to further delegate their powers and lose a portion of their sovereignty as to have sufficient coordination, trust and diminished transaction costs towards tackling the root causes of the crisis. The establishment and further development of the ESFS exemplifies just that.

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Note: Beatriz Brunelli Zimmermann & Christopher P. Buttigieg (2023) A history of continuous power delegation: the establishment and further development of the European system of Financial Supervision, Law and Financial Markets Review, DOI: 10.1080/17521440.2023.2181671

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