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Closing ranks between prevention and management of systemic crises: A proposal to couple the ESRB with the ESM

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Abstract

On the occasion of related proposals by the European Commission and the Eurogroup, this paper proposes to entrust the ESM with the hosting of the ESRB in the medium term. The novel proposal aims at strengthening the macro-prudential expertise of the ESM and at enhancing the independence of the ESRB. Following a brief summary of related proposals, the main rationales and the key elements of the proposal are presented in detail.

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Keywords: financial stability, macroprudential policy and supervision, financial crisis prevention and resolution, conflict of interest, euro area

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The paper was prepared by the author in his personal capacity. The opinions expressed herein are the author's own and should not be interpreted as reflecting the views of the European Commission, DG FISMA, or the German Federal Ministry of Finance.

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1. Introduction

As reaction to the global financial crisis and the subsequent European sovereign debt crisis, two new institutions were established in Europe. While the European Systemic Risk Board (ESRB) was created as macro-prudential watchdog to oversee risk in the financial system and to contribute to the prevention of financial stability risks, the European Stability Mechanism (ESM) was set-up - as successor of the European Financial Stability Facility (EFSF) - to provide stability support to Member States as prompt measure of crisis management in order to safeguard financial stability. Despite the naturally high interrelatedness of prevention and management of financial stability risks, both institutions have been established independently and, by now, there have been no indications for close cooperation or exchange between them. This is also reflected in the way the two reform proposals by the European Commission for both institutions are currently discussed – separately and in isolation from one another.

This paper argues, firstly, that both reform proposals should be discussed together in light of the envisaged new role of the ESM as common backstop to the Single Resolution Fund and the critique as regards the current hosting-model of the ESRB. Secondly, it introduces the novel proposal to link both institutions by entrusting the ESM with the hosting of the ESRB in the medium term. This would close ranks between prevention, mitigation and management of systemic crises and would ensure that financial stability is safeguarded in a more comprehensively manner.

The present paper aims at adding a novel element to the ongoing debate on a reform of the financial and economic governance of the European Union and, in particular, the euro area. It sheds light on the links between the two institutions that have so far not attracted much attention. The proposal corresponds to a related proposal as regards the surveillance of fiscal and macroeconomic policies. Embedded in a broader reform package, a group of 14 economists from Germany and France have proposed to transfer the role of the fiscal and macroeconomic watchdog to the ESM or another independent body to address current governance issues (Bénassy-Quéré et al. 2018).

The following section summarises the recent reform proposals on the ESM by the European Commission and the Eurogroup and on the ESRB by the European Commission. The next section discusses the rationale for a strengthening of the macro-prudential expertise of the ESM and for an improvement of the hosting structure of the ESRB. Section 4 presents the detailed reform proposal and section 5 concludes.

2. Recent reform proposals by the European Commission and the Eurogroup

2.1. Reform proposals on the ESM

The ESM was established in October 2012 at the height of the sovereign debt crisis (see profile in box 1). The Member States and the European Commission agree on the important role it has played since its inception. The ESM is safeguarding the stability of the euro area by providing financial support to countries that are experiencing severe financing distress as their regular access to market financing is impaired or is at risk of being impaired (European Commission 2017c, Eurogroup 2018).

Going forward, the European Commission and the Eurogroup agree that the ESM should be enhanced and reinforced:

- In December 2017, the European Commission has tabled a proposal for a European Monetary Fund (EMF) that would succeed the ESM and would be established as a legal entity under EU law[1] (European Commission 2017c). In addition, the proposal of the European Commission foresees that the EMF would be able to provide a common backstop to the Single Resolution Fund (SRF) by providing credit lines or setting guarantees in support of the Single Resolution Board (SRB)[2].
- In June 2018, the Eurogroup (2018) achieved a consensus that a reinforced ESM will provide the common backstop to the SRF in the form of a revolving credit line. It was agreed that this would be part of a broader reform in order to reinforce the ESM while conditionality will remain an underlying principle of all ESM instruments. In the future, the ESM should take a stronger role in the design and monitoring of programmes. Following IMF practice, some Member States have suggested that the ESM should also be enabled to assess the overall economic situation in the Member States and, when appropriate, may also facilitate the dialogue between Member States and their creditors. The Eurogroup, however, rejected the proposal by the European Commission for an immediate incorporation into EU law and suggested a decision on the matter at a later stage, as long as key features of the ESM governance are preserved.

Both the proposal by the European Commission and the agreement of the Eurogroup foresee that the ESM should provide a common backstop to the SRF. The common backstop is considered as a last resort measure and would be called on only in a crisis situation in which the resolution of a failing credit institution is necessary to preserve financial stability of the euro area and the means of the SRF would not be sufficient to resolve this systemic crisis. While this new task of the ESM relates very much to the prevention of systemic crises, neither the European Commission nor the Eurogroup make a reference to macro-prudential policy as an element of crisis prevention or suggest how the expertise and the competence of the ESM as regards macro-prudential policy could be strengthened.

Box 1: Current set-up of the ESM

Mandate and competences of the ESM

The European Stability Mechanism (ESM) was set up in October 2012 as a successor to the European Financial Stability Facility (EFSF) which was established in June 2010. The purpose of the ESM, as defined in Article 3 of the ESM Treaty, is to mobilise funding and provide stability support to ESM Members experiencing, or threatened by, severe financing problems. This support can only be provided under strict conditionality and if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States. Such

[1] According to the European Commission, the institutional structure of the ESM would be preserved (see European Commission 2017c).

[2] The proposal comprises further changes as regards decision making, the management of financial assistance programmes and the development of new financial instruments. However, these features will not be discussed here as this discussion paper focuses on another potential element to enhance the ESM/EMF.

conditionality may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions (Article 12 (1)). The ESM treaty foresees five instruments for the provision of stability support: precautionary financial assistance (Article 14), financial assistance for the recapitalisation of financial institutions of an ESM Member (Article 15), ESM loans (Article 16) and primary or secondary market support facility (Article 17, 18). In addition, the ESM direct recapitalisation instrument for euro area financial institutions has been established as an additional instrument by the Board of Governors in 2014. The six instruments clearly reflect the crisis management function of the ESM. The ESM can raise funds by issuing financial instruments or by financial or other arrangements with ESM Members, financial institutions or other third parties.

Organisation of the ESM

The ESM Treaty establishes the following organisational structure: A Board of Governors (Finance Ministers of ESM Member States) as highest decision-making body, a Board of Directors, as well as a Managing Director. The Managing Director serves as chief of the staff, is the legal representative and conducts the current business of the ESM.

The Board of Governors is chaired by the President of the Eurogroup, Mário Centeno, and the Board of Directors is chaired by the ESM Managing Director, Klaus Regling.[3] The Managing Director is appointed by the Board of Governors and, whilst in office, may neither be a Governor or a Director.

Activities of the ESM

Out of the six instruments available to the ESM, to date, only ESM loans and loans for indirect bank recapitalization were used. Loans were provided by the ESM and the EFSF as its successor to Ireland and Portugal (EFSF), Greece (EFSF and ESM), and Cyprus (ESM). The loans were provided conditional upon the implementation of macroeconomic reform programmes and were negotiated on behalf of the ESM by the European Commission in liaison with the ECB and, where possible, the IMF. An ESM loan for indirect bank recapitalisation was, to date, only provided to Spain.[4]

The daily work of the ESM staff focuses on programme related tasks and financial operations. The former includes programme negotiations and discussions with other creditors as well as the monitoring of the economies of programme countries. Following the completion of a programme, an Early Warning System is implemented to continuously assess whether the beneficiary Member State is able to repay its loans.[5] The latter tasks comprise, for instance, managing of the paid-in capital of EUR 80.4 billion, raising money to finance lending operations, as well as monitoring liquidity risk and managing outstanding loans to programme countries.[6]

Staff and administrative costs of the ESM[7]

According to its annual report, the ESM employed 174 persons on 31 December 2017. The ESM incurred total staff costs of EUR 31.2 million and further costs of EUR 1.2 million for employees seconded from other International Financial Institutions, as well as interim and temporary staff hired from external agencies in 2017. Other administrative expenses amounted to EUR 27.8 million (excl. costs for seconded, interim and temporary staff).

[3] ESM, 2018, p. 60-63.
[4] ESM, 2018, p. 55.
[5] ESM, 2018, p. 14.
[6] ESM, 2018, p. 37.
[7] ESM, 2018, p. 106.

2.2. Reform proposal on the ESRB

The ESRB was established in December 2010 following the recommendation of the de Larosière group (see box 2). It contributes to the prevention or mitigation of risks to the stability of the financial system in the European Union by overseeing respective systemic risks and issuing warnings or recommendations for remedial action in response to risks identified.

As required by the ESRB Regulation, the European Commission carried out a review of the ESRB and concluded that it is generally well-functioning (European Commission, 2017b). Hence, its proposal published in September 2017 foresees only a couple of limited changes (European Commission, 2017a): Firstly, it is proposed that the ECB President becomes the Chair of the ESRB General Board on a permanent basis. Secondly, the creation of the Banking Union is taken into account by proposing that the Single Supervisory Mechanism and the Single Resolution Board should also become voting members of the General Board and that the ECB should be included as a possible addressee of ESRB warnings and recommendations related to its respective supervisory tasks. With regard to the appointment of the Head of Secretariat by the ECB, it is, thirdly, proposed to introduce a consultation procedure in which the General Board would examine the candidates proposed by the ECB. At the same time, it is foreseen that the Chair may delegate tasks related to the external representation tasks of the ESRB to the Head of Secretariat. The proposal is currently under discussion in the European Parliament and in the Council.

Box 2: Current set-up of the ESRB

Mandate and competences of the ESRB

The European Systemic Risk Board (ESRB) was set-up in December 2010 with the mandate to oversee risk in the financial system and to contribute to the prevention or mitigation of systemic risks to financial stability in the European Union. The founding Regulation (1092/2010) stipulates, in particular, the following tasks: analysis all the relevant and necessary information, identification and prioritization of systemic risks, and close cooperation with other supervisory authorities. While the ESRB cannot enact legally binding instruments, it can issue (i) warnings where systemic risks are deemed to be significant and (ii) recommendations for remedial action in response to risks identified. Both instruments are subject to a "comply or explain" mechanism and, therefore, are non-binding which reflects the more preventive role of the ESRB as a macro-prudential watchdog. The design of the ESRB followed a respective recommendation by the de Larosière group (European Commission, 2009a).

Organisation of the ESRB[8]

The founding regulation foresees the following organisational structure for the ESRB: General Board as highest decision making body, a Steering Committee, an Advisory Scientific Committee (ASC), an Advisory Technical Committee (ATC) and a Secretariat. The ESRB General Board and the Steering Committee are currently chaired by the President of the ECB, Mario Draghi. The ASC is currently chaired by Professor Javier Suarez, the ATC by Philip R. Lane, Governor of the Central Bank of Ireland. Francesco Mazzaferro

[8] ESRB, 2018, p. 55.

serves as Head of Secretariat and was appointed by the ECB (in consultation with the General Board of the ESRB).[9]

Activities of the ESRB

According to its Annual Report 2017, the ESRB hosted 33 active working groups and organised 126 internal meetings and 357 teleconferences in 2017/2018 to perform its assigned tasks.[10] In addition, the ESRB held a number of conferences and workshops to facilitate a dialogue between policy makers and researchers[11] and launched a series of annual conference in 2016. Between 1 April 2017 and 31 March 2018, the ESRB has published 3 recommendations, 5 opinions, 1 compliance report, 3 occasional papers, 8 ESRB reports, 32 working paper and 10 other ESRB publications.[12]

Staff and administrative costs related to the ESRB[13]

In its current role as hosting institution, the ECB supports the ESRB by providing the ESRB Secretariat in accordance with the European Regulations 1092/2010 and 1096/2010. This includes the provision of analytical, statistical, logistical and administrative support. According to the ESRB annual report, the support was provided by 60.6 ECB (full-time equivalent) staff members in 2017; thereof 28.8 persons within the Secretariat and 31.8 persons involved in other forms of support. Other member institutions of the ESRB provided approximately 64.7 (full-time equivalent) persons for analytical support for the ESRB working groups.

The ECB incurred direct costs of EUR 9.3 million and indirect costs of an unknown amount for other shared support services (e.g. human resources, IT, general administration).

3. Rationale for coupling the ESRB with the ESM

3.1. Strengthening the macro-prudential expertise of the ESM

After the outbreak of the global financial crisis in 2007, the governments of most European countries found themselves forced to stabilise the financial system by providing guarantees to banks in financial distress or even bailing them out. These actions have significantly affected public finances. The government interventions coupled with the budgetary effects of the following recession have led to a severe deterioration of fiscal positions and a substantial increase in debt-to-GDP ratios in most European countries.

Empirical research suggests that the negative effect of banking crises, comparable to the crisis following 2007, amounts to an average medium-term increase of more than 35 percentage points in the government gross debt-to-GDP ratio (Furceri and Zdzienicka 2012).[14] Particularly, vulnerable banking systems characterised by weak bank profitability, low asset quality and a weak capital base pose a threat to public finances (Tagkalakis 2014). Besides the direct effects, the more indirect effects of financial crises in form of deeper and longer recessions, notably following house and equity price busts, are well documented (e.g. Claessens et al., 2012). Especially, the bust of mortgage booms is followed by considerably lower growth rates (Jordà et al., 2016).

[9] Article 3 (2) of Regulation 1096/2010.
[10] ESRB, 2018, p. 55.
[11] ESRB, 2018, p. 56.
[12] ESRB, 2018, Annex, pp. 58-63.
[13] ESRB, 2018, p. 55.
[14] Furceri and Zdzienicka (2012) define medium term as eight years after the crisis.

The global financial crisis turned into a European sovereign debt crisis when government financing costs peaked in some countries of the euro area and their market access was impaired or at stake. In order to safeguard financial stability, the European Financial Stability Facility was created in 2010 and succeeded by the European Stability Mechanism (ESM) in 2012 at the height of the sovereign debt crisis. Their mandate was restricted to the (ex-post) provision of stability support under strict conditionality and neither a preventive (ex-ante) monitoring of risks to financial stability nor a macro-prudential watchdog role were foreseen for the ESM (see box 1 for an overview of mandate, competences and activities). However, there is a case for a more preventive role of the ESM as this might avert the materialization of risks to the stability of the financial system ex ante. Therefore, the financial stability expertise of the ESM should be strengthened in order to enable the ESM to identify and analyze potential risks for financial stability that could deteriorate public finances as the ultimate consequence.[15] A strengthened ESM could then also take the role of a macro-prudential watchdog. Moreover, it could be justified to involve the strengthened ESM in macro-prudential policy making or at least in the coordination of macro-prudential policy at the European level.

Regarding the analysis of potential risks for financial stability, the IMF and its Financial Sector Assessment Program (FSAP) might serve as a blueprint: The objective of the FSAP assessments is to gauge the stability and soundness of the financial sector and to assess its potential contribution to growth and development. It is mandatory for those jurisdictions with systemically important financial sectors to undergo assessments under the FSAP every five years (since 2013: 29 jurisdictions). The FSAP findings are also used as input into the broader surveillance exercises of the IMF ("Article IV consultations").[16]

Strengthening the macro-prudential expertise and role of the ESM becomes even more relevant if the ESM provides a common backstop to the Single Resolution Fund (SRF) in the future (see section 2.1). Recall that a situation in which the SRF has to call upon the common backstop would have been preceded by a massive threat to the stability of the financial system caused by one or more systemically relevant banks that are failing or likely to fail. Moreover, the common backstop would need to step in only when the losses and the cost of resolution are so high that they cannot be covered by the write-down of shares, the bail-in of debt instruments (write-down and/or conversion) and the use of the industry financed means of the resolution fund. Such a situation would clearly constitute a financial crisis with severe risks to financial stability. It is the first and foremost objective of macro-prudential oversight to identify and analyze such risks well in advance, to prepare and, then, to take appropriate preventive measures. If the provision of the common backstop is assigned to the ESM, it should be enabled to build-up the necessary capabilities and be equipped with the required resources.

[15] Tagkalakis (2014, p. 176), for instance, concludes his analysis by suggesting that "macro-prudential supervisors should be in close coordination with fiscal policy makers to monitor the links between financial market and fiscal policy developments, i.e., financial stability and fiscal policy risks should be jointly analyzed."
[16] See the IMF Factsheet on the Financial Sector Assessment Program, IMF 2018.

3.2. Strengthening the independence of the ESRB by adjusting its hosting model

The ongoing discussions in the Council of the European Union and in the European Parliament on the governance of the ESRB provide an appropriate occasion to reassess the current hosting model of the ESRB (see box 2 for a brief profile). The two co-legislators are currently discussing the proposal that entails selected changes to the ESRB governance and was published by the European Commission in September 2017 (see section 2.2).

The proposal of the European Commission does not entail major amendments to the ESRB governance or its hosting model; instead it foresees that the President of the ECB should chair the ESRB General Board on a permanent basis.[17] The proposal and, in particular, the provision as regards the ESRB Chair gave rise to much discussion. The Dutch Government, for instance, was explicitly called on by its parliament to speak out against the proposal that the ECB Presidents chairs the ESRB General Board permanently as this would prevent a serious recognition of systemic risks related to the ECB's monetary policy stance.[18] In the European Parliament's public hearing on the ESRB Review, also de Larosière (2018) expressed his doubts whether the ESRB - being completely linked to the ECB - has both the authority and independence to alert about all relevant risks for financial stability. Instead of further integrating the ESRB into the ECB, de Larosière proposed to reinforce the independence of the ESRB vis-á-vis the ECB.

Table 1: Likely Instances of Conflicts between Monetary and Macro-Prudential Policies

	Inflation above target	**Inflation close to target**	**Inflation below target**
Financial exuberance (boom)	Complementary	Independent	Conflicting
No imbalance	Independent	Independent	Independent
Financial deflation (bust)	Conflicting	Independent	Complementary

Source: Beau et al. (2014).

The fundamental issue here is how monetary policy and macro-prudential policy interact and whether conflicts between both policy fields may arise. Hellwig (2014), for instances, highlights that the monetary policy objective and the financial stability objective do not necessarily coincide and conflicts will arise when both policies are assigned to one institution. He cautions that macro-prudential powers might be used for monetary policy purposes if monetary policy goals and macro-economic considerations dominate. In the same vein, Beau et al. (2014) categorise possible scenarios for the relationship between the two policy fields. They identify times of excessive increases of asset prices ("financial exuberance") with inflation rates below target and times of asset price busts ("financial deflation") with inflation rates above target as scenarios in which conflicts between monetary policy and macro-prudential are likely to occur (see table 1). The occurrence of such policy conflicts might outweigh the

[17] Article 5 of the current ESRB Regulation (1092/2010) stipulates that the ECB President should be Chair of the ESRB General Board for the first five years after the establishment of the ESRB in 2010 and that the Chair for the subsequent terms should be designated in accordance with the modalities determined on the basis of a review due by 17 December 2013. As no new designation modalities have been put in place, the ECB President has continued to chair the ESRB General Board after December 2015 (European Commission, 2017b).

[18] The Dutch Government was called on by the House of Representatives of the Netherlands to "speak out clearly against the proposal [by the European Commission] that the President of the ECB should become the permanent President of the ESRB" given that otherwise "systemic risks caused by the ECB are not recognised enough [by the ESRB]" (Motion no. 1295, adopted on 13 February 2018, own translation by the author). Out of 13 party groups, 11 voted in favor of the motion (House of Representatives of the Netherlands, 2018).

benefits in terms of reduced coordination problems when same institution is entrusted with both policies. This concern is of particular relevance given the financial stability implications of the current low interest rate environment and the current monetary policy stance of the ECB. With regard to the hosting of the ESRB by the ECB, this provokes the question whether the ESRB is prone to a conflict of interest between the monetary policy objective of its hosting institution and its own financial stability objective.[19] Such a conflict of interest would endanger the ESRBs role as macro-prudential watchdog as it could, for instance, impede an open and frank discussion of the financial-stability implications of the current low interest rate environment. Against this background, it is at least questionable whether the ESRB is independent enough to issue a warning or recommendation addressing macro-prudential risks that might result from the low interest rate environment when needed.[20] Strengthening the ESRB's autonomy and independence vis-à-vis the ECB could solve this issue.

Similarly, a conflict of interest might arise with regard to the ECB's supervisory tasks within the Banking Union. The recent proposal by the European Commission (see section 2.2) takes these concerns into account and includes the ECB as a possible addressee of ESRB warnings and recommendations related to those tasks conferred to the ECB by the Single Supervisory Mechanism Regulation (Regulation 1024/2013). While this would legally authorise the ESRB to issue such a warning or recommendation it does not solve the conflict of interest issue: If a warning or recommendation to the ECB in its role as bank supervisor is needed, the ESRB Chair, the Head of Secretariat and his team, all being ECB staff, will steer or prepare the drafting. The Advisory Scientific Committee of the ESRB (2013) has highlighted that the central role of the ECB within the ESRB and the fact that the ECB President is the Chair of the ESRB could be highly detrimental to the ESRB's ability to issue warnings and recommendations related to the ECB's supervisory tasks.[21] Hence, it is an open question whether a warning or recommendation addressing the ECB in its role as supervisor will be issued when needed. This will largely depend on the independence of the ESRB and, therefore, disentangling the ESRB from the ECB would contribute to limiting any doubts in this regard.

The discussion about the hosting model of the ESRB is not new. In the run-up to establishment of the ESRB, the European Commission had assessed alternative hosting models including the option of a hosting by the European Commission itself (European Commission 2009c), but it decided to propose the present ECB-hosted model (European Commission 2009a, b) and provided the already existing expertise for macro-prudential issues at the ECB as main argument in favor (European Commission 2009c).[22] However, times have changed since then. Macro-prudential oversight and macro-prudential policy are no longer unchartered waters with Central Banks as exclusive knowledge carriers and many experiences have been gained. There is, in particular, a growing experience with the application of macro-prudential instruments by

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[19] The issue was also raised in the public consultation held by the European Commission (2017b) in 2016.
[20] This was the major concern underlying the above mentioned motion of the Dutch Parliament (House of Representatives of the Netherlands, 2018). Also de Larosière (2018) questioned the authority and independence of the ESRB to alert about respective risks given the current hosting model.
[21] The issue was raised by stakeholders in the consultation held by the European Commission (2017b) in 2016.
[22] Goodhart (2012) argues similarly in his throughout discussion of alternative design options for macro-prudential institutions at the national level when he argues that the newly created Macro-Prudential Authority of the UK should be part of the Bank of England.

designated authorities outside the Central Bank sphere.[23] Alternative models for the hosting of the ESRB should now be at least conceivable, if not tantamount. This would also address concerns that the close link between the ECB and the ESRB may negatively affect the public perception of the ESRB as an autonomous body (European Commission 2017b).

To sum up, having the ECB as hosting institution of the ESRB entails significant synergies, but this hosting model is prone to a potential twofold conflict of interest that might arise between the financial stability objective of the ESRB and the monetary policy objective and the supervisory role of the ECB as hosting institution. As the potential twofold conflict of interest is highly detrimental for the role of the ESRB as macro-prudential watchdog and its public perception as autonomous body, alternative hosting models should be considered to strengthen its independence in the medium term. As Central Banks continue to be the most experienced institutions as regards macro-prudential policy, it will be important to ensure their continued involvement. However, the growing experience with macro-prudential policy of authorities outside their sphere highlights that alternative institutional arrangements could be envisaged as well.

4. Proposal to couple the ESRB with the ESM

4.1. Details of the proposal

The section above highlights the need to strengthen the macro-prudential expertise and the surveillance competence of the ESM and the need to enhance the independence of the ESRB in order to avoid potential conflicts of interests in the current hosting model. It is therefore proposed to refine the hosting model of the ESRB by transferring to an ESM-hosted model in the medium term and to enhance the macro-prudential expertise of the ESM. This will also bring the ESM closer to an IMF-type model which combines the surveillance function with the conditional provision of financial resources to countries in financial distress. The proposal builds on eight key elements which are laid out in the following.

1. **Adapt the hosting model by transferring the ESRB to the ESM**
   The current hosting model has raised critique and concerns as regards the independence of the ESRB in delivering on its mandate as macro-prudential watchdog. The main concern are potential conflicts of interest between the monetary policy objective and the supervisory role of the ECB and the macro-prudential policy objective of the ESRB. A transformation of the ESRB into a European agency similar to the three ESAs might not be appropriate to solve the identified issue. Instead, the hosting model of the ESRB should be adapted by entrusting the ESM with its hosting. This adaption of the hosting model would also reflect that the interests of both institutions will be even more aligned after the introduction of the common backstop than today. Both institutions will, then, have the objective to avert financial stability risks that could pose a threat to the stability of the financial system and, thereby, could trigger a call on the common backstop to the SRF or endanger the stability of public finances of an EU Member State.

[23] The ESRB Macroprudential Measures Database entails of all notified macro-prudential instruments applied by Member States. The Database is accessible on the website of the ESRB. In addition, ESRB (2017) provides an overview of the authorities designated for the application of macro-prudential instruments.

2. **Maintain the current board structure of the ESRB**

The current board structure of the ESRB with members of the National Central Banks, the National Competent Authorities as well as members from the European Central Bank and the European authorities is one of the main strengths of the ESRB and should therefore be kept. This will ensure a continued involvement of the current ESRB members and will enable them to provide their expertise and relevant data to the General Board of the ESRB and the respective committees and working groups also in the future.

3. **Ensure continued membership of Central Banks in order to benefit from their expertise**

This proposal aims at avoiding the potential conflict of interest related to the current hosting model of the ESRB. It does not aim at excluding the European Central Bank or the National Central Banks from the ESRB General Board or the respective committees. To the contrary, the membership of the Central Banks and their participation in the General Board and the respective committees is considered as the main virtue of the ESRB. It also accounts for the task to contribute to the conduct of policies related to the stability of the financial system which is assigned to the European System of Central Banks in the Treaties.[24] Hence, the European Central Bank and the National Central Banks should continue to be members of the ESRB despite an amended hosting model. Thereby, they could continue to provide their expertise, data and analytical capacities to the ESRB and the respective committees.

4. **Transfer of the ESRB Secretariat to the ESM**

Assigning the hosting of the ESRB to the ESM will require a transfer of the ESRB Secretariat to the ESM. This will affect roughly 30 staff members of the Secretariat and potentially further 30 staff members providing other forms of support (see box 2). If a direct transfer is not possible, the ESM could also set up a new secretariat for the ESRB. Details will have to be elaborated at a later stage.

5. **Build-up of a dedicated macro-prudential unit at the ESM**

Beside the hosting of the Secretariat of the ESRB, the ESM should also enhance its own financial stability expertise and, therefore, set up a dedicated macro-prudential unit. This will enable the ESM to prepare own independent risk assessments and to participate and contribute to ESRB committees and working groups. This would also contribute to the surveillance competence of the ESM (similar to the IMF).

6. **Provide the ESM with one (voting) member in the General Board**

The Managing Director of the ESM should become a voting member of the General Board of the ESRB in order to ensure its participation and to enable a continuous contribution of its expertise to the ESRB. Accordingly, the ESM should participate in the respective committees and working groups like the Steering Committee and the Advisory Technical Committee. If the Chair of the General Board of the ESRB does not become a full-time position, the Managing Director should assume the position of the Chair.

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[24] In accordance with Article 127(5) of the Treaty on the Functioning of the European Union, Article 3(3) of the Statute of the European System of Central Banks and of the European Central Bank stipulates that they shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system.

7. **Consider the appointment of an independent full-time Chair of the General Board of the ESRB**

All members of the General Board including the ESM Managing Director as its Chair are ex officio members on the basis of their main full-time position.[25] As they can at best devote only a limited amount of time to the work of the ESRB, it could also be considered to upgrade the position of the Chair of the General Board to a full-time position and to appoint an independent expert instead of assigning this position to the ESM Managing Director. This could also contribute to an increased visibility of the ESRB itself.

8. **Reassess the distribution of voting rights among the members in the General Board**

The suggested reform of the ESRB could be used to reconsider the current dichotomy among the members of the General Board. At the time when the ESRB was set-up it might have been reasonable to have mainly Central Bank Governors as voting members and confine the Heads of Competent Authorities to a role of non-voting members given the fact that Central Banks were almost exclusive knowledge carriers as regards macro-prudential policy. In light of the experiences gained by many National Competent Authorities in the implementation of macro-prudential policy over the last years, this dichotomy could be reconsidered.[26]

Taking into account the envisaged new role of the ESM as common backstop, the overarching goal of this proposal is to enable the ESRB and the ESM to deliver even better on their mandates to safeguard financial stability in future. Therefore, the proposal and its eight key elements strive to achieve the two following objectives: i) to strengthen the macro-prudential expertise and surveillance competence of the ESM and ii) to tackle the critique as regards the limited independence of the ESRB that could hamper its role as macro-prudential watchdog. The former objective will be achieved by setting up a dedicated macro-prudential policy unit at the ESM. The latter objective will be attained by disentangling the ESRB from the ECB and entrusting the ESM with its hosting in the medium term. This would more or less eliminate the potential conflict of interest between the ESRBs financial stability objective and the ECBs monetary policy objective or banking supervision tasks. However, it will be crucial to ensure a continued participation of the European Central Bank and the National Central Banks in the ESRB in order to benefit from their expertise. The proposal of an ESM-hosted model for the ESRB would also create synergies both for ESRB and ESM, given that macro-prudential oversight and the design of stabilization programs requires (to some extent) similar skill profiles, as has been demonstrated by the IMF.

4.2. Consideration of potential conflicts of interest, institutional design and legal issues

The proposal aims at enhancing the macro-prudential expertise of the ESM and at addressing the issues raised concerning the limited independence of the ESRB. Nevertheless, it is worth to reconsider that a major critique of the current hosting model was the potential conflict of interest between the ESRB and its hosting institution (see section 3.2). Obviously, this problem might arise in any case in which the ESRB is hosted by another institution - including a hosting by the ESM. There are, however, good reasons that the potential for conflicts of interest

[25] The Chair and the two Vice-Chairs of the Advisory Scientific Committee are an exception as they have no full-time position at the ESRB Advisory Scientific Committee, but are also voting members of the General Board.

[26] See ESRB (2017) for an overview of the designated authorities.

between ESRB and ESM would be much more limited. First, the objectives of the ESRB and the ESM are more or less aligned: Both aim at averting risks which could endanger the stability of the financial system and could lead to a call on the common backstop to the SRF or to a massive deterioration of public finances of a Member State. Second, while ESRB and ESM might also have different views on the effects of monetary policy, none of them is responsible for setting the interest rate level.[27] Thus, both institutions should be able to express their views on the implications of a particular policy stance while fully respecting the independence of the ECB. Third, as the ESM as potential host of the ESRB is not involved in the micro-prudential supervision of financial markets intermediaries and market participants, the ESRB would be more able to openly express its concerns and issue warnings or recommendations if it deems supervisory practices as insufficient. Hence, the potential for conflicts of interest between ESRB and ESM appears to be relatively limited. Moreover, remaining concerns could be accommodated by upgrading the position of the Chair of the General Board to a full-time position and appointing an independent expert as Chair as suggested above.

Key element of this proposal is the transfer of the ESRB to the ESM. While the ESRB is an institution of all Member States and enshrined in EU law, the ESM is an institution of the Member States of the euro area and based on the intergovernmental ESM treaty. Here it is important to distinguish between the question of institutional design and the question of legal implementation. As regards the institutional design, the proposal would not deviate much from the current set-up given that both the ESM and the ECB are institutions for the euro area, i.e. the ESRB as institution for all EU Member States is already today hosted by an institution of the euro area.

The purpose of this paper is to present the proposal and its key elements together with the (economic) rationale behind it. Therefore, the important question of legal implementation is not discussed here. In this regard, it might be of particular relevance how the ESM as - currently - intergovernmental institution can host the ESRB as institution established under EU law. But in view of the SRF which is established under a mixed system of EU law and an intergovernmental agreement it is not implausible that an appropriate legal solution can be found even if the ESM remains an intergovernmental institution in the future. This question will have to be looked at in the future if the proposal is considered further.

5. Conclusion

Recently, reform proposals have been presented for the ESM and the ESRB. With regard to the ESM, both the European Commission and the Eurogroup have proposed to entrust it with the provision of a common backstop to the Single Resolution Fund. Selected changes were proposed for the ESRB by the European Commission. This paper tries to shed light on the links

[27] In case of a continued environment of low interest rates, the ESRB might focus on implications for the financial sector (e.g. buoyant risk taking, excessive increases of asset prices, deteriorating profitability of banks) whereas the ESM might appreciate the reduced financing costs for governments and in particular for governments of those Member States that are currently in a program or are likely to apply for a program in the future. However, strong ties remain between ESRB and ECB even in case of an ESM-hosted ESRB as the Governors of all National Central Banks of the Eurozone are both members of the Governing Council of the ECB and the General Board of the ESRB.

between both institutions and proposes to strengthen the macro-prudential expertise of the ESM and to entrust it with the hosting of the ESRB in the medium term. This will address the concerns raised in relation to the currently limited independence of the ESRB.

The present proposal would bring the ESM closer to an IMF-type model by combining the surveillance function with the role as provider of financial resources (under conditionality) to countries in financial distress. The proposal builds on eight key reform elements: 1) the ESM should become the hosting institution of the ESRB; 2) the current board structure of the ESRB should be maintained; 3) the continued membership and active contribution of the European Central Bank and the National Central Banks has to be ensured; 4) the ESRB Secretariat should be transferred to the ESM; 5) at the same time the ESM should set-up a dedicated financial stability unit to strengthen its own macro-prudential expertise and surveillance competence; 6) the Managing Director of the ESM should become a (voting) member and should serve as Chair of the General Board of the ESRB; 7) alternatively, one could consider upgrading the position of the Chair of the ESRB General Board to a full-time position and appointing an independent expert and last but not least 8) the current dichotomy among members of the General Board as regards voting rights could be reexamined.

There are two rationales for the novel proposal outlined above: first, already the current mandate of the ESM suggests to strengthen its capabilities for identifying, monitoring and addressing risks to financial stability given the deteriorating effect of financial crises on public finances. This will become even more important with its extended role as common backstop to the Single Resolution Fund. Second, the ability of the ESRB to objectively identify and preventively address all financial stability risks has been questioned publicly given its limited independence due to the current hosting model. The main concern here is that the ESRB might be rendered ineffective as macro-prudential watchdog because of a potential conflict of interest caused by the threefold role of the ECB as monetary policy maker, as part of the SSM and as host of the ESRB with its financial stability mandate. Strengthening the macro-prudential expertise of the ESM and entrusting it with the hosting of the ESRB in the medium term would address the above mentioned issues.

One might question whether replacing one host by another host really solves the conflict of interest issue. And, indeed, the danger of a conflict of interest will be present in any hosting model. But the potential for a conflict of interest between the ESRB and the ESM would be much more limited as compared to the current model. The interests of the ESRB and the ESM are more aligned and the ESM is neither involved in monetary policy making nor in micro-prudential supervision. Also the difference in the membership of the ESM and the ESRB should not be an issue: It is already today the case that the ESRB, which is an institution for all Member States of the EU, is hosted by the ECB, which is an institution for the euro area only. As the purpose of this paper is to add a new element to the ongoing debate on the reform of Europe’s financial and economic governance, priority was given to the presentation of the general concept and its (economic) rationale. Important questions of legal implementation will have to be assessed if the proposal is considered further.

The proposal outlined above would constitute a fundamental change to the architecture of the ESRB, but minor reforms might not be sufficient to ensure that financial stability risks are addressed in a more comprehensively manner.

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