



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

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Miroslav Kalousek
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Dear Miroslav

EUROPEAN FINANCIAL REGULATION AND SUPERVISION

We have now seen Jacques de Larosière's report on EU Financial Market Supervision and I thought it would be helpful to set out our thinking, especially as we work towards the G20 Finance Ministers meeting here on the 14th March.

It has always been clear that the financial services industry is global. Whatever we do in the EU must be consistent with this – we must have regard to developments in other parts of the world. As part of this we need to be clear about what is and should be dealt with supra-nationally and what needs to be dealt with on a national basis. We all recognise that problems can arise in one country and very quickly affect others. Therefore we need much greater co-operation. However whatever we do, globally and within the EU, needs to be workable. In that spirit I therefore welcome Jacques de Larosière findings, which are I think a good basis for further discussions.

Alongside action to deal with the problems we currently face, the EU must therefore respond to ensure that we have effective crisis arrangements in place to prevent, manage and resolve future crises in the financial system. In parallel to the work at the international level, at the G20 and the London Summit in April, the EU must consider and revise its own supervisory and regulatory arrangements.

I believe that the growing interconnectedness of financial markets within the EU means that we should consider fundamental reforms to the system of regulation



and supervision. While I do not believe that this has been the key cause of the difficulties in our financial markets in recent months, I do believe that it has contributed to problems within markets and made them more difficult to resolve. We should not shy away from radical options, if that is the right thing to do.

We need to approach these issues with some important principles in mind:

- Prudential and conduct-of-business issues cannot be separated and need to be considered together. Problems in the mortgage-backed securities market in the US and in many other markets demonstrate that conduct-of-business regulation can be as critical for financial stability as prudential regulation. Moreover, conduct-of-business failings within a firm can lead to its own prudential failure. It is therefore essential that national and international arrangements support the necessary collaboration on prudential and conduct issues.
- Supervisory and crisis-management arrangements need to be consistent and aligned. Responsibility for managing the resolution of financial crises – including fiscal support – remains an important consideration in designing supervisory and regulatory structures. Supervisory authority needs to be aligned with fiscal responsibility and this will be a very significant factor in limiting the extent to which national supervisors can devolve responsibility for the supervision of firms to a centralised body.
- EU arrangements need to fit with global practice. We must always consider how our EU architecture matches that of our international counterparts and – increasingly – the global institutions such as the FSF, the IMF, and the global standard setters.
- Through all of this we must continue to support the development of open, global markets. The development of EU supervisory and regulatory arrangements must not in itself become a barrier to more integrated global markets – or indeed put at risk the integrity of the Single Market.
- Independence and accountability. Freedom from political influence is important for effective financial supervision and the development of technical financial rules, in line with international best practice. But equally, financial regulators and supervisors must be accountable for



their actions, and must ensure that they develop their rules and practices through effective engagement and consultation.

Considering these principles – and Jacques de Larosière’s report – I would like to set out four proposals to form the basis for the EU’s response:

- First, recent events have shown the need to bring together understanding of macro-economic and financial market issues. They have also pointed to the need for financial regulation to be better designed and implemented around macroeconomic developments. I therefore believe that we need an effective early warning system bringing together macro-economic and financial market issues, to involve supervisory authorities, central banks and finance ministries. The design of this body will require much further consideration. It is right that the ECB should play an important role in this independent body, alongside the central banks in non-euro countries such as the Bank of England. Supervisory authorities from across the EU must also participate, although it clearly should not have direct powers over supervisors. The body must also interact effectively with the new FSF-IMF early warning arrangements.
- Second, we have made significant progress in converging financial regulation. But it is clear that this process continues to face some obstacles. One continuing difficulty is that the rule-making arrangements are split between three committees of national supervisors. Another problem is that this process fails to meet the tests for independence and accountability set out above. I therefore propose that, over time, we move to bring together the three committees of national supervisors into a single body. It should have a stronger role in rule-making, and an explicit objective to iron out national divergences. Over time, this body should become the source of technical financial rules, rather than national authorities or the Commission. It would also be a forum through which supervisors would increase dialogue and cooperation. I also propose that the new body be given an independent status, separate from the Commission, but with clear lines of accountability to the Council. It would interact effectively with the FSF and regulatory authorities elsewhere in the world in developing financial rules, as well as the global standard-setting bodies. In short, it would, over time, become a regulatory authority and a forum in which the effectiveness of national supervisors can be peer reviewed. But it would not supervise



individual banks, insurers or investment firms, leaving that to national authorities, including through more effective colleges, given that arrangements for resolving difficulties in these firms remain a national responsibility. Similarly, it would not have powers over national supervisors, for example to change supervisory decisions, and it would not prescribe detailed supervisory practices.

- Third, we continue to see the closer integration and consolidation of EU financial infrastructure. This offers significant economic benefits - so long as it is effectively regulated and supervised. However, it is striking that payments systems, clearing systems and settlement systems have little if any pan-EU regulation. The development of rules for clearing and settlement systems in particular should be a priority - through the usual EU legislative procedures and, in future, the new independent rule-making body. These rules must improve operational and prudential standards while reinforcing the Single Market. Just as a bank from any Member State can offer accounts in any currency, so a clearing or settlement system in any Member State should also be able to provide services in any currency, if meeting high EU standards.
- Finally, recent events have shown the difficulties of dealing with some cross-border business models. As Jacques de Larosière's report sets out, cross-border banking through branches presents particular risks. I therefore propose a fundamental review of the risks and safeguards around cross-border branching models, to consider issues such as the relative responsibilities of home and host authorities for the oversight of groups' financial strength, effective cooperation between national deposit guarantee schemes, and the lack of guarantee schemes for the failure of cross-border insurance companies in many Member States.

It will, of course, be essential for ECOFIN to take the lead role in the development of further thinking in these areas over forthcoming months, to inform decisions in the European Council, and I hope that you find this letter a useful contribution to that debate.



I am copying this to ECOFIN colleagues, the President of the European Central Bank, and Commissioners Barroso, Almunia, Kroes and McCreevy.

Yours sincerely

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ALISTAIR DARLING