FINANCIAL STABILITY AFTER THE GLOBAL FINANCIAL CRISIS: A COMPARISON OF THE ESRB AND THE FSOC

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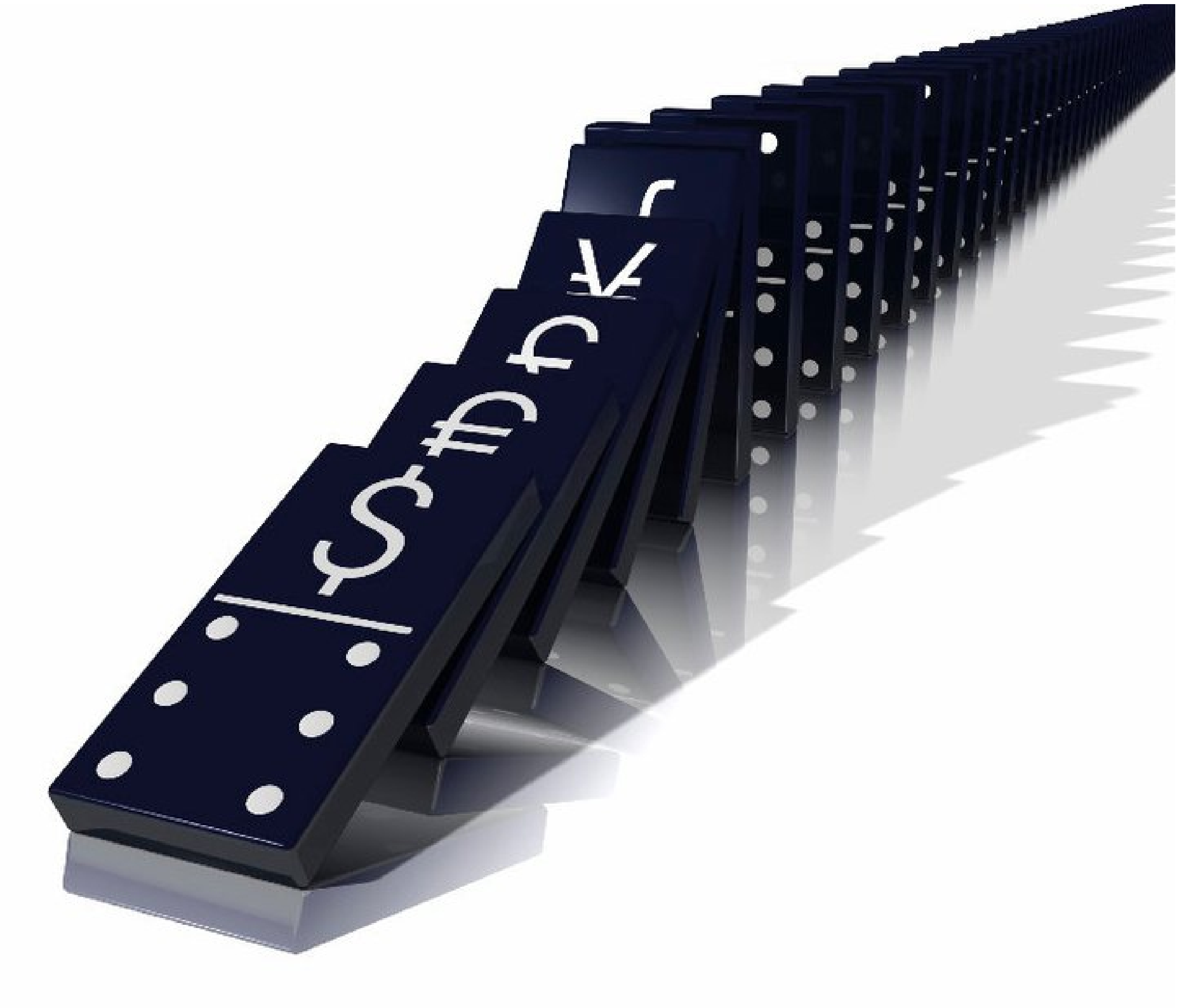

ABSTRACT

This paper describes the definitions of financial stability in the EU and USA used to set-up the financial stability oversight committees after the recent financial crisis. It thereby develops a methodology to describe financial stability mandates and uses descriptive material to identify similarities and differences of the two models.

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1. INTRODUCTION

The financial crisis has hit the USA and EU heavily, whereby lasting damage might harm some individual markets and countries for a longer timeframe. They reacted by establishing several policy mechanisms to detect and mitigate future crisis. Among these were macroprudential oversight commissions such as the European Systemic Risk Board (ESRB) and the Financial Stability Oversight Committee (FSOC) designed to warn if risk in financial markets is to increase in the future. Little research has been done on the definition of financial risk by the institution mainly due to the novelty of financial stability as an actively pursued pubic policy goal. Therefore this research begins to develop a methodology, with which to categorize definitions of financial stability.

During the last months the economic outlook of the Eurozone and the USA has gradually improved. The injection of liquidity by governments and longer-term public commitment helped the financial sector to stabilize, but also burdened future tax-payers heavily with debt. An in-depth description of the developments during and evaluation of the measures taken after the crisis are now key for a prevention of future distress to the economy. A comparison between the European and American oversight committee will help to show similarities, differences, strengths and weaknesses of the two approaches. In a more and more globalized world, the two regional blocks have to work closely together in order to ensure the attainment of their goal, whereby similar structures would be of great help. Most research has been done before the establishment of the FSOC and the ESRB. Therefore there is a need for in-depth investigation of the rules, whereby this research mainly aims at a throughout description and study of the institutional structure. The main idea here is that by characterizing the understandings of financial stability the political options and needs for change on each side of the Atlantic become more apparent. Furthermore this research adds to the body of knowledge by structuring the understanding of institutions through the development of a methodology on financial stability.

The structure of the paper begins with outlining the mandates and structure of the FSOC and ESRB. A reflection on the ideas on financial stability follows, whereby a way to distinguish two models in approaching the subject is outlined. Lastly there is the analysis of the mandates and institutional set-up followed by some conclusive remarks.

2. FSOC and ESRB

In order to be able to fully understand the notions of financial stability in each region, an outline of the basic ideas behind the FSOC and ESRB have to be given. They were chosen to be the subject of interest when studying definitions of financial stability as opposed to micro-prudential supervision authorities in order to understand the broad picture. Firstly the mandates of the institutions, which have been established pursuant to the awakening of the crisis will be described here. Secondly a brief description of the institutional set-up of the FSOC and the ESRB within the larger structure is given. For the EU it is enshrined in Regulation 1092/2010, which draws upon the treaties due to its nature as an international organization. The mandate for the ESRB is thus:

"The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the

Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth."

For the USA the mandate stems from the Dodd-Frank act, Section 112, which is also quite recent legislation. Before the crisis neither of the two agencies even existed.

"(1) IN GENERAL. —The purposes of the Council are—

(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, inter-connected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

(B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and

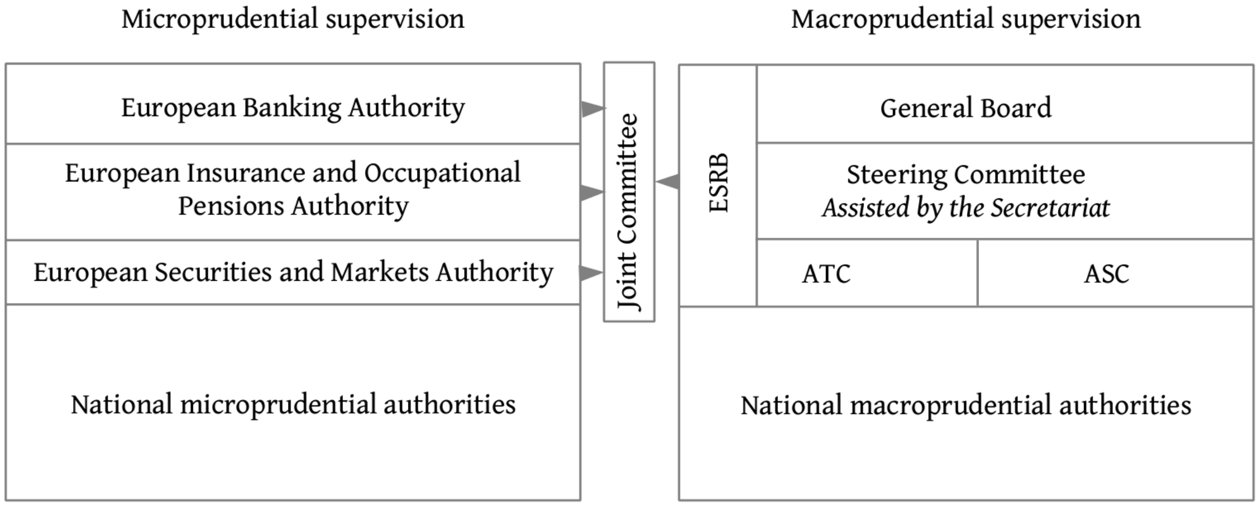
(C) to respond to emerging threats to the stability of the United States financial system."

The ESRB and the FSOC have been implemented in two different institutional settings under different legislative conditions. The most prominent issue of course is sovereignty of the states, which is fairly unimportant in the US federal system, but of prime importance in the EU, where issue of competences often precede considerations of effectiveness (although the two determine each other). The European Systemic Risk Board (ESRB) was established by Regulation 1092 (2010) as recommended in the high-level group chaired by de Larosiere in 2008. As pointed out by Pan (2010) it can be seen as fulfilling the desire of the EU to shift a substantial power in the field of financial supervision away from the member states. It is part of the European System of Financial Supervision (ESFS) and responsible for macro-prudential oversight of the European financial market. The national authorities received their mandate from the respective national legislative for the domestic financial market and are responsible within the framework of the ESRB. Thus for risk at the European level the ESRB holds the authority. At the same time several microprudential European Supervisory Authorities (ESAs) were established on EU Level complementing the respective national authorities. The ESRB consists of a General Board, which brings together 37 voting members, namely

- President and Vice-President of the ECB
- the governors of the national central banks
- the chairs of the ESAs
- a member of the European Commission
- the chairs and vice-chairs of the Advisory Scientific Committee (ASC) to the ESRB and the Chair of the Advisory Technical Committee (ATC).

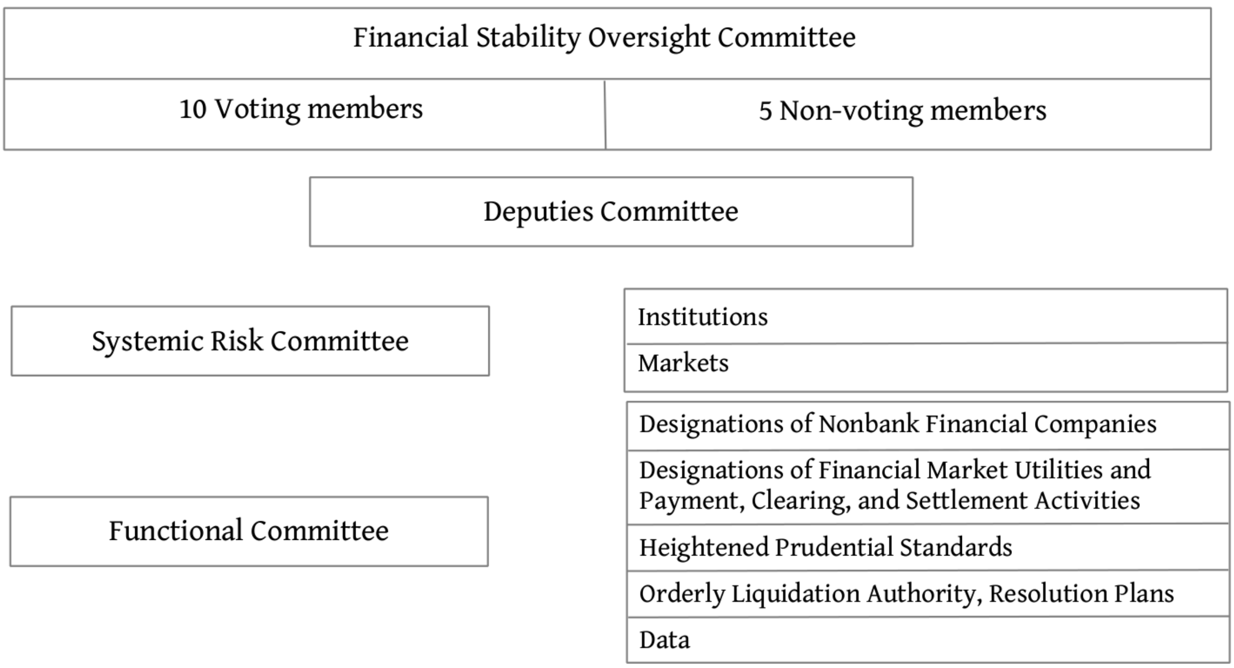
Besides these members holding a vote, there are also the President of the Economic and Financial Committee and one representative per member state from the competent national supervisory authority as the 28 non-voting members. The ESRB is furthermore supplied with a secretariat and a steering committee which have the task to prepare the meetings and in case of the latter also to review the work of the general board. (ESRB, 2012) The financial stability of the ESRB derives from article 127 (5) and (6) of the Treaty of the Functioning of the European Union (TFEU).

Picture 1: Institutional set-up of the ESFS



The ESRB is part of the ESFS, which consists of the ESAs and the ESRB, which can produce a joint committee if necessary. The ESAs are heir to the level three committees in the Lamfalussy model and represent the unique structure of two level approaches in the EU. On the level below there are the national prudential supervisiory authorities. There are further levels of intertwinement in this picture nonetheless due to members of one authority being represented on the other. The ESRB is the best example, since it brings together the Committees of the ESRB, ECB, the ESAs and the Commission in the Steering Committee, joined by the governors of the national central banks in the general Board. It has to be noted that the use of institution in this paper differs from the understanding of institution in EU law, since the ESRB does not have legal personality.

Picture 2: Institutional set-up of the FSOC



The Financial Stability Oversight Committee (FSOC) was established by the Dodd-Frank Act, an extensive piece of legislation, which deals with the insights into the risk present in financial markets gained after the crisis. It is smaller in size with ten voting members, namely

- the Secretary of the Treasury,
- the Chairman of the Board of Governors of the Federal Reserve System
- seven members of the federal financial regulators from the various currency, consumer protection and credit commissions and agencies
- an independent member with insurance expertise

There are furthermore five non-voting members consisting of the Directors of the Office of Financial Research, the Federal Insurance Officer, a state commissioner for each insurance, banking and securities with two-year terms. (FSOC, 2011) The FSOC has a similar internal structure compared to the ESRB, although it lacks the general council format. This is due to the fact, that issues of macroprudential policy are dealt with at federal level in the USA, thus the inclusion of the states is not necessary – besides the fact that with close to twice as many states the number of representatives would be highly impractical.

3. THEORY

"A second reason why science cannot replace judgement is the behavior of financial markets."— Martin Feldstein

After the financial crisis the writing on financial risk has changed, reflecting the fact that many aspects of the concept were unknown. Today a lot of questions remain, but the discussion of financial stability has produced several arguments as to how one could include the lessons from the crisis into our understanding of financial stability. The difficulty of defining financial stability often has been argued is due to it being a negative concept in practice, namely the absence of risk. Monetary stability on the other hand is a positive concept since a clear indicator to aim for has been defined (either the price level or the inflation rate, Schinasi, 2003). Therefore in monetary stability there is a clear goal to reach, whereas in financial stability it is often defined much more unclear as crisis prevention. The problems in definition are also connected to the fact that monetary stability is almost always the primary goal of the central bank, whereas financial stability is quite ancillary.

In order to reflect on the possibilities of public action, the nature of financial risk has to be understood. There is a two-step process connected to risks of banking instability: Firstly bank runs or other reasons for dried-up liquidity such as financial imbalances or negative aggregate shocks (Trichet, 2009) and secondly contagion between banks or national banking systems depending on the scale of measurement (Balogh, 2012) cause a widespread crisis. Externalities, asymmetric information and feedback and amplification mechanisms are features of financial systems aggravating these problems (Trichet, 2009). Governments and central banks can intervene in two different ways opposing a financial crisis. Instruments of regulation and prudential supervision are mainly applied to prevent a financial crisis. These can be divided into instruments monitoring the degree of risk-taking and those that look at the inter-linkages and common exposure of banks. But once it arrived the state might try to mitigate the financial crisis by providing emergency liquidity. The better the first set of measures is executed, the less and less often emergency funds have to be utilised. Furthermore especially since the recent crisis insurance schemes to unburden states from the costs produced by such measures have been widely discussed. (Schinasi, 2003)

In any case financial stability is the property of a system (Allen and Wood, 2006), which does not contain any risk in its perfect form. Since this is impossible in reality, definitions of financial stability are aiming to define it in such a way, that no rigor mortis to use the words of Allen and Wood (2006) is applied. Therefore defining financial stability tries to capture the right amount of risk the system can be exposed to. One strand of definitions does so by defining the properties of a stable system, another by defining the amount of risk the system can be exposed to. Cihak (2007) distinguishes the definition by the level of significance of the shock and the exposure. He thus names a definition which is just based on the idea that it is the antithesis of a crisis narrow. A definition which allows for events, which result in the fragility of the system to increase, is thus a broader one. Since a broader definition includes more potential risks, he also finds that the reports are longer the broader the definition. A problem both share is, that a crisis is normally triggered by an unforeseen risk. Thus the definitions have to capture something, which is usually not part of economic knowledge at this point. In the following paragraphs these possible definitions will be outlined and concluding a short insight into the definitions of the EU and the USA are given.

Firstly there is the school of thought defining the properties of a stable system. Schinasi (2003) defines financial stability as the "*joint stability of the key financial institutions operating within financial markets and the stability of those markets*". This definition thus has two components, which are put together in the "*optimal saving-investment plan of an economy*" by Haldane (2004) or summarized by Klomp as the "*smooth functioning of the various components of the financial system*" or "*smooth intermediation*" by Liebeg and Posch (2011). He therefore does take a very demanding view on the degree of risk allowed and including notions of efficiency into the concept. Schinasi (2003) is less demanding in defining a stable financial institution as having "*sufficient capital to absorb normal and at times abnormal losses and sufficient liquidity to manage operations and volatility in normal periods of time.* " The problem with this strand of literature is, that it is not connected to any observable feature contrary to the following approach, where a crisis can be captured by economic indicators.

The other strand of literature defines systemic risk and thus financial instability as the situation where risk is minimised and crisis unlikely to occur. Martinez-Jaramillo et al. (2010) defines systemic risk with two components. Firstly there has to be an initial random shock and secondly a transmission mechanism, generally called contagion. Patro (2012) provides again a very broad definition by defining systemic risk as distress to the entire financial market affecting also the real economy. The definition of Allen and Wood (2006) also emphasizes this distress of the real economy, which is a feature that eases the way of measuring the concept. But they are conscious about choosing to define episodes of financial instability as opposed to systemic risk or minor financial crisis, which always persists in some form. They thus define such episodes as points in time when innocent bystanders "*experience financial crises which are not warranted by their previous behaviour, and where these crises collectively have seriously adverse macro-economic effects.*" Haldane (2004) criticises this approach for not capturing the root cause of instability and the channels through which the shocks are handed on to the real economy. Both ways of approaching financial stability of course include both kinds of public measures.

But definitions based on the properties of a stable system tend to emphasize the importance of regulation in general and preventive measures in particular, since even instability is seen to disrupt the system. The other strand of definitions hinge more to the idea that stability is a matter of degree and therefore especially if a crisis occurs government action has to be prompt.

Another important concept that should be mentioned in connection to systemic risk are *systemically important financial institutions* (SIFIs). These are single institutions, which fulfill a systemic function and/or are of such size as to endanger the stability of the system in case they fail. Patro (2012) uses size and the four C's (contagion, concentration, correlation and conditions) in order to measure systemic importance not only of banks, but of any firm. Contagion, as explained earlier refers to the vulnerability of the market to the failure of one firm. Concentration refers to the case, when a single firm holds a large share of the market, which can not be easily covered by other market participants or new entrants at the firm's exit. Correlation is the case, when many market participants are exposed to the same kind of risk, which aggregates to a common exposure of systemic significance. Lastly conditions can be a source of systemic risk if closure policy is not independent from these "*states of nature or some macro-financial conditions*". (Thomson, 2009)

Based on this understanding of the two models of financial stability, we can derive two models what the regulation should look like. Firstly a definition of financial stability that emphasizes the stability of the system will regulate more heavily than one that is purely interested in the absence of a crisis. Degrees of fragility and the efficiency have to be observed, thus the monitoring and regulatory framework has to extend to this part of the definition. With respect to centralization the more emphasis is put on the stability of the system, the more pressuring become the arguments for a centralized system. This assumes that more centralized structures and stronger mandates are more effective in regulating the overall system, given that the system is not overregulated. This approach furthermore assumes that the understanding of financial stability was correctly translated into the institutional structure and indeed represents the will of the population.

4. RESEARCH QUESTION

The beginning point for this research was the establishment of the European Systemic Risk Board (ESRB) and the Financial Stability Oversight Comittee (FSOC), which was proclaimed AS an important step towards more stable financial markets. When looking at the wording for each of the institutions there seems to be a difference in the emphasis on risk and stability. The resulting question as to whether there is indeed a difference between the models of how financial stability and risk are perceived, lead to the following research question.

How far apart are the American and European understanding of financial stability?

The broad line on which the research concentrates are the legal boundaries and political choices when establishing the ESRB and the FSOC. It is thus generating a methodology using descriptive research to determine the current definition of financial stability in the USA and EU on the meso level. Although of course several factors such as the concentration of the banking market, the independence of the central banks and other supervisory institutions and the risk-taking adversity of the market may have influenced the constitutional choices, this research will focus on describing the understanding of financial risk and not try to find a causation. At first it seems strange to attribute the concept of an understanding to a political organization or a state. Its representatives may have personal understandings, but in how far can a country have a general understanding of such an intricate subject as risk. The legal mandate and the institutional set-up are expressions of a nation as to how it understands risk, since it represents the collective will to organize risk supervision and regulation in that manner. Based upon the two models of defining financial stability the mandate and the institutional design of the FSOC and ESRB are investigated on the lines of the following sub-questions:

1. *Does the strength of mandates for financial stability regulation in the EU and the USA differ?*
2. *Does the strength of the central institutional set-up in the EU and the USA differ?*

A definition aiming at a stable system has to produce a strong mandate for the supervisory institution since it has not only to guarantee the absence of a financial crisis, but to monitor the exposure and shocks of the system continuously. Also ensuring efficiency may be part of the tasks. A definition aiming only at the absence of a crisis can produce a weaker mandate with more dispersed institutions since shocks and exposure only have to be monitored upon a certain level of significance.

Table 1: Models for the definition of financial stability

	Stable system	Absence of a crisis
Significant shock	No	Yes
Significant exposure	No	Yes
Efficiency	(Yes)	No
Importance of SIFIs	More	Less
Hypothesis	↓	↓
Mandate	Strong	Weak
Institution	Central	Dispersed

5. RESEARCH DESIGN

The Research Design is a comparative case study of the EU and the USA. The focus lies on the legal mandate and the institutional design for financial stability. One can either choose for a strong regulatory institution, which is very independent from the legislator and enjoys a large room for maneuver and a high degree of authority. On the other side of the scale there is weak regulator, which is fragmented, bound by a very confined path of action and highly dependent on the implementing of procedures by other bodies. The indicators have been established according to the subheadings of the legal documents investigated. I would like to first pay attention to the legal side of the mandate, thereby clarifying the boundaries to which the second set of criteria, namely political actions are subject. (Allen and Wood, 2006)

Table 2: Criteria to determine the power of the mandate

1. Legal mandate	2. institutional design
1.1 Explicit/implicit mandate	2.1 Vertical division of power
1.2 Extensive/narrow mandate	2.2 Unitary/federal system
1.3 Flexible/strict mandate	2.3 Accountability
1.4 Information disclosure	2.4 Single/Shared external representation
1.5 Binding/advisory decisions	

5.1. Legal definition

The legal mandate an institution receives draws the boundaries to the possible action. An explicit mandate enables the institution to defend its authority in front of the legislator and competitive agencies. Furthermore the definition of financial stability is dependent upon the definition of the financial system. Therefore the wider this definition, the more policy options the agency is able to achieve within the given legal boundaries. A flexible mandate ensures freedom of action for the respective institution. Another important point with reference to financial stability is its relation with monetary stability. Whereas the latter is an inherent objective of every central bank and supervisory system, financial stability has been on the agenda only recently boosted through the crisis. The analysis of these points should lead to an answer to the question how strong the mandate of the institution is.

5.1.1 Explicit/implicit mandate

For the definition of a mandate this research follows the lines of the Bank of International Settlements (2011) by defining a mandate as a *"combination of the responsibility and authority to wield state powers in pursuit of public policy objectives"*. An explicit mandate is grounded in a legal document, which outlines a clear demand for action from the legislators to an agency. A very explicit mandate includes the agent's responsibilities, authority and power and the state's objectives. Implicit mandates are for example constructed by necessity or effectiveness in order to reach a goal outlined in an explicit mandate. Reasons for an implicit mandate are general principles of law, tradition and extra-statutory statements. Before court it is more difficult to construct a logical argument for action from an implicit mandate than from an explicit mandate. Therefore a strong financial stability mandate should be explicit.

The most common way to construct an implicit mandate is via monetary stability. Monetary stability is often the prime objective of all central banks. Financial stability was added mostly in recent decades and especially after the crisis, although their interconnectedness was always acknowledged (Bingham, 2010). Often central banks thus have a weak mandate in financial stability compared to their competences in the field of monetary stability (Frangakis, 2011), which is defined by Schinasi (2003) as *"the stability of the price level or the inflation rate over some well-defined medium-term time horizon."*

Monetary and financial stability can be seen as reinforcing each other. The argument here is that a stable financial system strengthens monetary policy by shielding it from major financial shocks. Successful monetary policy reduces procyclical tendencies and thus contributes to financial stability. (BIS, 2009) On the other hand they can also be seen as conflicting, especially if the market is highly concentrated with several systemically important financial institutions

(SIFI). If a tightening of monetary policy places the financial institutions at risk, the central bank is caught in a trade-off situation. An independent body is more or less appropriate depending on the chance of conflict in the objectives and the need for consistency for the institutions. (Schinasi, 2003) The two different models argue thus for more or less supervisory power at the central bank. The question in which relation financial stability stands to monetary stability is highly important. If the institution is requested by its mandate to provide for monetary stability primarily and financial stability is only implicit in its mandate, the decision to pursue monetary stability in a situation asking for a trade-off is already pregiven. If the two have at least an equal mandate the decision to pursue the objective of financial stability is also possible, thus contributing to a strong definition of financial stability This indicator thus weights financial stability in the context of multiple tasks for one agency.

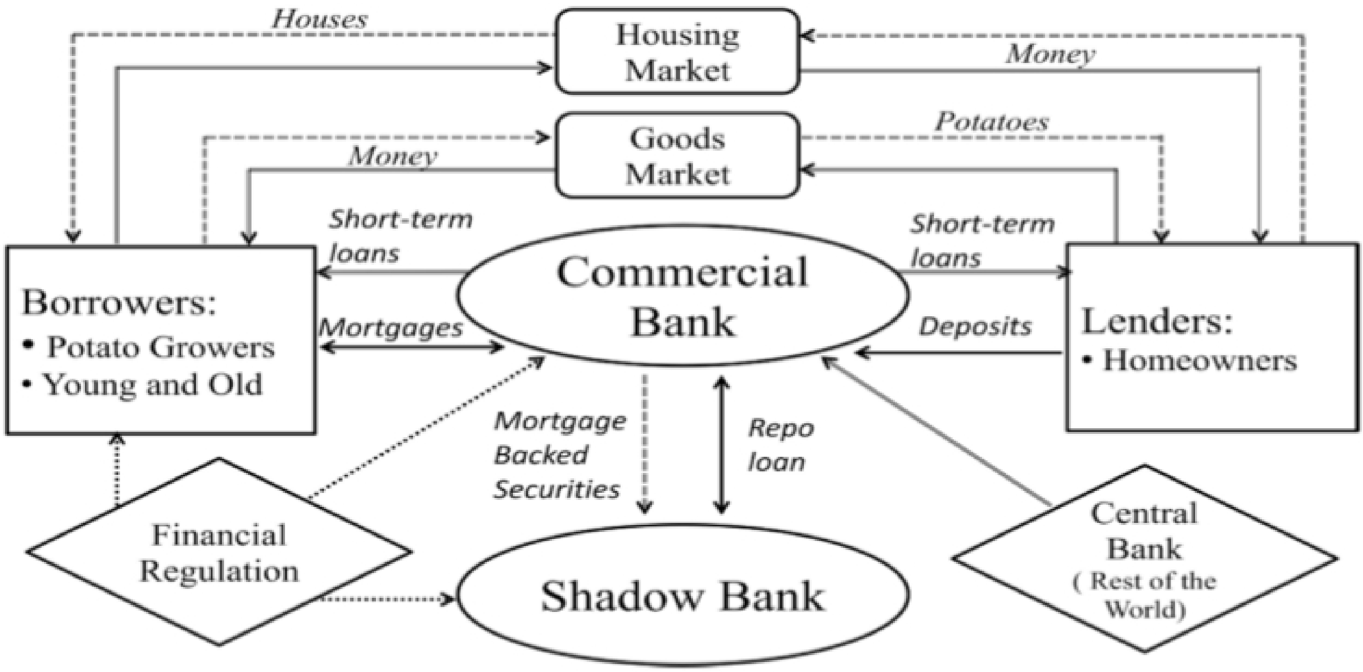
5.1.2 Extensive/narrow mandate

The more extensive the objectives are the larger the variety of mission goals and objectives, in short: policy options. A larger variety of policy options gives the institution more freedom to act and the power to decide on the appropriate policy instruments themselves. It thus contributes to a strong definition of financial stability for the supervisory body. Following the broad lines of the Bank of International Settlements (2011), an extensive mandate gives the supervisory authority an unqualified objective, whereas it is more constrained if the objectve is related to a certain direction (e.g. promote) or function of the supervisory body (e.g. bank supervision). The categorization of the objectives is more complicated since there is no precise measurement for financial stability and often it is a shared responsibility including other government agencies (Bingham, 2010). In this research the lines of Cihak (2007) are followed, which has been described during the discussion of financial stability in chapter 3. It is mainly dependent on the idea of significant exposure and shocks to determine the extensiveness of a mandate.

5.1.3 Flexible/strict mandate

A mandate is more or less flexible if the underlying definition contain a larger realm. The broader the underlying assumptions are, the more power the institutions holds since it regulates a larger part of the system and is more flexible in the approach it would like to take. Therefore a more flexible mandate contributes to a strong definition of financial stability. In the case of financial stability it is the definition of the financial system, that defines the range of institutions to which the decisions of the body apply. Since we are looking at political institutions for the definition of a financial system one has to look at the political entity (in this case a nation state and an international organisation), of which financial stability is supposed to be a feature. An interesting case here is how foreign institutions are treated.

Picture 5: A model of the financial system



adopted from Vardoulakis (2012)

Secondly the definition of the financial system is dependent on the kind of institutions, which are included. It is very narrow to confine a financial market only to banks (especially if we look at the role of shadow banking in the recent crisis). One can thus also include insurance companies, large companies or at the other extreme any systemically important institution. (Allen and Wood, 2006) In order to characterise this structure of the economy and financial services the model of Vardoulakis (2012) is used. It describes well the different actors, which are in the markets and the role of financial regulation to order the relationship between borrowers and the banks.

5.1.4 Information disclosure

Information quality is very important to the correct fulfillment of the task of macro-prudential supervision, especially with regard to SIFIs (Masera, 2010). As Pan (2010) argues a supervisory agency, which is able to ask for the disclosure of detailed information about a company's financial condition, trading activities and investment portfolio is *"the most powerful agency in the regulatory system"*. It therefore can be logically argued that an extensive disclosure policy contributes to a strong mandate. This indicator has two dimensions with respect to the manner and kind of information one is able to ask. Firstly an institution is more powerful if it can determine the information it needs and at most extreme point to be able to gather it on its own. Secondly the degree of detail expressed in whether information disclosure may be about individual firms (and thus SIFIs) is also an important point. The degree of detail of course should be appropriate to the level of concentration of the financial sector. A regulatory agency may be able to ask for more detailed information than another, but if the market is far more centralized than in other countries this mandate may still not be appropriate.

5.1.5 Binding/advisory decisions

The last point, which is to be regarded is the degree to which the decisions of the body have binding effect or just an advisory function. The advisory role can come with varying degree of requesting actions. If the agency can decide on the course of action on its own the regulatory agency can be seen as having a strong mandate with complete freedom. On the other end of the spectrum there is just an advisory function. In between there are such forms of governance as the explain-or-comply mechanisms or a co-decision authority shared with another agency.

5.2. Policy choices

The policy choices made when establishing an institution constitute the feasible options inside the legal realm. With regard to the institutional design, the vertical division of power gives clues on the centralization of the system. If micro and macroprudential oversight are highly intertwined and there is just one institution for the different markets (banking, insurance and securities), the agency can be seen as quite centralized. Furthermore one of the most important indicators is the degree to which decisions are made on the federal or quasi-federal level as opposed to the member states. Accountability is an important indicator for attitudes towards financial risk and a difficult topic since publication of possible risk can dry up markets. The Financial Stability Board (FSB) established by the G20 is a vital body to ensure financial stability across the globe. Being able to influence the representation there is an important factor of shaping the international definition of financial stability and represents an internal bargaining chip. For an overview of the named criteria see Table 1.

5.2.1 vertical division of power

Closely linked to the concept of financial stability is macroprudential oversight, which has been one of the main points of innovation after the crisis. It describes the oversight of the whole market and system-wide risks, as opposed to microprudential oversight, which focuses on individual institutions. Macroprudential oversight can mean identifying large bank holdings, which pose a risk due to their size, but also common movements of smaller banks resulting in the same accumulation of risk. The important aspect is the the involvement of the central bank, which has received its mandate in order to guarantee a continous steering of monetary policy in first instance. There are various approaches as how to steer financial stability. Some argue that it needs the same continuity as monetary stability, others believe that financial stability should be handled closer to the legislators. (Schinasi, 2003) Depending on the approach the degree of involvement of the central bank is defined.

5.2.2 Unitary/federal system (horizontal)

In a unitary system the number of veto players is smaller and all authority is centralized. The difference between vertical and horizontal division of power is, that the entities are different in terms of the subject they supervise in the former and the territory in the latter. Both the EU and the USA have a federal character since they are composed of member states, which retained some power in financial stability. Schoenmaker (2011c) proposes the idea that there is a financial trilemma with regard to financial stability, integration and national financial policies, whereby just two objectives can be realized at the same time. The approach and market of the EU and USA are examined as to which model is chosen here. Another important question in macro-prudential supervision is e.g. which agency deals with a large bank that is registered in multiple states.

5.2.3 Accountability

The more accountable a system is towards the public, the less centralized it is. Instead of dispersing the power to lower levels of authority though, the public plays a larger role. It is entrusted with the task of ensuring good governance by the regulatory body. Accountability is a difficult topic in the financial sector since even posing the question, whether a financial institution is sound in its risk-taking behaviour may alert the market. Accountability is conceptualized as the publication of records as well as the number and kind of hearings before the legislative body.

5.2.4 Single/Shared external representation

External representation at the Financial Stability Board (FSB) is a decisive factor for a strong definition of financial stability for the oversight bodies. It not only ensures a voice at the outside, but also increases the power balance in the domestic political system for the supervisory authority. The Financial Stability Board can be seen as the appropriate way of measuring external representation since it is the core of the financial cooperation on the international stage. It has been set up by the G20 and is hosted by the bank of international settlements. (Enria et al., 2011) Potential rivalry institutional structures such as the World Trade Organization and the Organization for Economic Cooperation and Development are also taking part in the FSB. (Donelly, 2010, FSB, n.d.) Thus one can conclude that representation at the FSB is a valid measurement for external representation.

6. ANALYSIS

6.1. Legal definition

Firstly the mandates of the institutions will be analysed according to the set of criteria in Table 3. Thereby the legal texts will serve as the main basis with the mandate being investigated first and the legal boundaries to the decisions afterwards.

Table 3: Indicators for a strong mandate

1. Explicit/implicit mandate
2. Extensive/narrow mandate
3. Flexible/strict mandate
4. Information disclosure
5. Binding/advisory decisions

6.1.1 Explicit/Implicit mandate

'Never let a good crisis go to waste' - Rahm Emmanuel

The ECB has first of all has a mandate for monetary stability, but in Art. 127 (5) and (6) there are also some ancillary provisions for financial stability. The reasoning behind this is that financial stability is important to monetary policy – the headline of the chapter containing Art. 127. If one compares the mandates of monetary and financial stability of the ECB, the former is primary and there is no question that financial stability is ancillary. Since this is part of the TFEU it can be seen as the general perception of the relation between the two in the EU. Regulation 1092/2010 states the mandate for safeguarding financial stability referring to Art. 114 of the TFEU, which deals with harmonization measures of the internal market. This is quite striking since in this article (contrary to for example Art. 127 (5), which refers to the stability of the financial system) was not taken as the legal basis for the ESRB. The ECJ allowed to establish a union body as a harmonization measure in case C-217/04. The ESRB can be traced to be built on the same reasoning, since national macro-prudential regulatory agencies failed their job as could be seen in the works on the recent crisis. A union body is thus necessary to ensure the stability of the financial market. In any case Art. 114 provides a very strong legal basis giving sole competences to the Union (the ESAs have been established under the same provision). Both bodies share that the idea that the supervisory body is subject to the central bank, yet an independent body. This reflects the issues, we could already observe with the dual mandate of monetary and financial stability. The central bank's main objective is the former and the ESRB and FSOC have been established to ease issues of conflicting interests, when executing their dual mandate.

Thus concluding it can be stated that there exists an explicit mandate for the ESRB to conduct its review of financial stability in Regulation 1092/2010. The mandate of the FSOC is also explicit in the Dodd-Frank Act in section 112 (a) (1). Therefore we can conclude that both enjoy the same explicit mandate in terms of responsibility, authority and power of the agency being fixed.

6.1.2 Extensive/narrow mandate

The first point of attention with respect to the extensiveness of the mandate is the mission and purpose of the supervisory bodies. The largest difference in the mandates is the focus of the EU on emergency situations in order to avoid another financial crisis, whereas for the USA the focus lies on large, interconnected bank holdings (SIFIs). The reason for this may be found in the fact, that the trigger of the crisis for the USA is widely seen as being such holdings, whereas for the EU systemic contagion and especially the linkages with the USA appear more important. Both mandates can be seen as including unqualified objectives. There is no direct link to any part of the financial system and both are requested to be responsible for the market without any restrictive constraints or directional terms.

With respect to the broadness of the mandates measuring on the lines of Cihak (2007) the EU's approach is definitely closer to prevention of a financial crisis than to financial stability. But it is also not the narrowest definition possible, since it does not refer to a full-blown financial crisis, but periods of financial distress. Furthermore it is followed by a broader notion, where the main idea is the smooth functioning of the internal market. For the USA the definition is different but equal in broadness, since it refers explicitly to the promotion of market discipline (= smooth functioning of the market) and the response to emerging threats (= periods of distress). Therefore the objective is here stability and not the avoidance of fragility.

Many of the objectives in the two documents correspond as can be seen in Table 4. But the most striking difference is the focus on emergency situations in the EU (Article 2 (e)), which completely lacks in the USA. For the ESRB the management of emergency situations seems key, whereas it does not find any mentioning in the American definition. This is partly due to the fact that the European Union as a monetary union cannot adjust individual monetary policy in case one of the member states experiences a shock. It also has to accommodate difference of opinion of the member states during crisis situations. Therefore a well-structured crisis policy is by far more important for the EU than in a nation state with a wider range of possible response mechanisms to a crisis. One also has to mention that contrary to the EU, the USA has a broader range of objectives (almost twice as many articles are directed towards warnings and four times as much text). It also results in a wider range of purposes for recommendations: The FSOC can request the supervision of a company, from which it then can also collect information through the Office of Financial Research. Furthermore it is to provide for a forum of discussion and the purpose of the annual report is set out in a separate article.

Concluding therefore the USA has a broader mandate not because the mandate is unqualified, but because the objectives are more various and spelled out. The definition of objectives is wider for the USA in terms of tasks conferred upon the FSOC, as well as the degree of detail with which these tasks are described.

Table 4: Similarities in the objectives of the ESRB and the FSOC

	EU	USA
Mandates	Regulation 1092/2010	Dodd-Frank Act
(see p. 1/2)	Article 3	section 112 (a) (1)
Objectives:		
collection of information	Sub-Article 2(a)	(2) (A), (B) and (E)
identification of risk	Sub-Article 2 (b) and (g)	(2) (C)
warnings and recommendations	Sub-Article 2 (c), (d) and (f)	(2) (D), (I), (J), (K) and (L)
Non-corresponding objectives	Sub-Article 2 (e), (h), (i), (j)	(2) (H), (M), (N)

6.1.3 Flexible/strict mandate

Having established that both agencies have an explicit mandate one has to take a closer look at how flexible their mandate is. In the EU the source of systemic risk appears a lot smaller defined since there just the financial system is included. Those outside the financial market place as explicitly stated in the American definition are not mentioned, which would constitute a very extensive definition basically allowing any organization to be a risk to financial stability. But in section 113 (5) it is clarified, that only financial activities are to be subject to the supervision of the FSOC, which effectively brings down the number of institutions to be considered. Using the model of Vardoulakis (2012) we see that in the European definition risk which is created in the upper half of the relationships ('the real economy') is left out of the picture. It stated later that the reason to uphold economic growth. In the mandate of the USA it is explicitly stated that also non-bank companies are to be included.

Furthermore the definition of financial holdings used is important for the scope of the mandate. Since in the American definition risk outside the financial services marketplace are included there we have two types of companies, which are relevant. The bank holding companies (Dodd-Frank Act, section 2 (18) (B)) and the nonbank financial companies, which each can be domestic and foreign. The definition of a bank in the USA dates back to 1956 - the Bank Holding Company Act. In section 4 (k) (4) activities, that are financial in nature are explained. The classic functions of banks (lending exchanging, etc.) are named (A), but also advisory services (C), the insurance sector (B) and dealing in interest and securities markets (D, E). In the EU the definition of the financial sector is a bit more complicated since it compromises a wider array of legislative acts, which are mainly based on the provisions for the building of the internal market. In general the definition is based on the three pillars of the European Supervisory Authority (ESA), which all are part of the financial markets. Just as in the USA banking (Regulation 1093/2010) is part of the financial market. This is split into credit institution (2006/48/EC), investment firms (2006/49/EC) and financial conglomerates (2002/87/EC), which all are defined through the legislation in brackets. The other parts are insurance and pensions (Regulation 1094/2010) and security markets (Regulation 1095/2010). The two thus can be seen as comprising comparable ideas with respect to financial institutions. The definitions then go on to define financial holding company, which can be referred to in general terms as

“ a financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, at least one of such subsidiaries being a credit institution” (Directive 2006/46/EC)

Since mixed arrangements can be the case here the term 'qualifying holding' is important, which is wider defined in the EU (10%, 2009/128/EC, 2002/83/EC) than in the USA (25%, Bank Holding Company Act, Section 2(a)).

Secondly one has to take a look at what constitutes a nonbank financial company. It is any company, which is predominantly engaged in financial activities without being a financial holding companies or an equivalent (see Dodd-Frank Act, section 102 (a) (4) (B)). The concrete implementation of this rule has just been approved recently (Board of Governors, 2013). A foreign nonbank financial company underlies the same definition, but is incorporated or organized in a country other than the USA. The EU also includes undertakings, “whose main business is of a similar nature” (Regulation 1092/2010), leading to the conclusion that the two definitions comprise the same realm here. These definitions are mainly aimed at including the various forms of shadow banking, which have been identified to be a cause of the recent crisis.

The last important point here is the difference between foreign and domestic banks. In the EU the distinction is more complicated since there is firstly the issue of internal establishments between the countries and secondly the issue of third country institutions. For the first case the principle of mutual cooperation is in place, whereby any permanent presence - even if it does not constitute a branch or agency - is to be treated as a branch or agency. The case of third country investment firms is covered by this definition as soon as they are authorised in a third country and comply with the prudential rules (Directive 2006/49/EC). This is also derived from the general principle of mutual recognition, on which the internal market is built. For the financial stability section of the Dodd-Frank act this is even further clarified by adding the understanding of the International Banking Act of 1978 (section 8(a)), which treats the distinction between foreign and domestic banks. Here the rules are analogue to the EU as to what constitutes a foreign bank.

Concluding thus one can state, that on first sight the US-definition of a financial system to be supervised by the FSOC is wider than the one of the EU. Wide parts of the definitions are nonetheless the same, such as the definition of financial companies and their equivalents. Only the definition of a financial holding company is bigger in the EU but it is restricted by Regulation 1092/2010. The power to supervise business undertakings outside the financial realm conferred to the FSOC (Dodd-Frank act, section 113, (C) (6)) is constrained by only limiting it to financial activity. In the end thus neither the American, nor the European definition span a larger realm, although their restrictions are differently worded.

6.1.4 Information disclosure

“Information is the currency of democracy." - Thomas Jefferson

With respect to information disclosure provisions neither the USA nor the EU have the right to ask for information directly from market participants. In the case of the USA the FSOC has to request the Office of Financial Research to submit report from any of the above defined entities (see section 2), if the information is not already available. If the information is not sufficient to determine, whether the entity should be supervised the issue is referred to the Board of Governors. (Dodd Frank Act, section 112, (d)). In the EU the ESRB may request information from the ESAs (Regulation 1093,4,5/2010), the ESCB (Regulation 1096/2010), the Commission and the national supervisory and statistics authorities and member states (Regulation 1092/2010, Chapter III). Contrary to the USA though the information has to be in aggregate form so that individual firms can not be distinguished. Information that is not in aggregate form has to be requested accompanied with a justification.

This difference in ways of requesting information is grounded in the difference in the definitions of financial stability. In the USA the concern about SIFIs is quite explicit whereas in the EU the macroprudential dimension is more prevalent. This is quite curious since it appears that the American banking market appears not as concentrated on first sight as one would think when looking at this definition. The average US credit institution holds 831 million, whereas in Europe the average credit institution holds 3,494 million. Furthermore there are more credit institutions per inhabitants in the USA (64 per 1 million) than in the EU (19 per 1 million). If looking closer though some of the largest credit institutions are located in the USA representing an asset concentration of 37,6% for the CR5, which is more than double than those in the EU 15 (14,5%). But if one looks at individual member states for several the levels of concentration exceed by far those in the USA. (De Noose, C., 2006, chapter 5.2.1) This is also reflected in the mandates, whereby the member states have larger mandates for the supervision of their national SIFIs. The ESAs are also more nationally dominated than the ESRB, whose main objective is to identify systemic risk to the EU arising from correlations among national SIFIs and other bank holdings. In how far these provisions are enough to be able to avoid information gaps as described by Enria et al. (2011) has to be seen in future.

Concluding one can state, that the two approaches with regard to the gathering of information are very different. Firstly the FSOC can request information quite easily, whereas the ESRB is dependent on the ECB in many ways. Secondly the kind of information available to the two institution is completely different in kind. The FSOC's focus is on company specific data, whereas for the EU information, where single institutions can be distinguished, is just to be accessed via significant hurdles of justification and bureaucracy. The FSOC has therefore a more extensive mandate for information disclosure

6.1.5 Binding/advisory decisions

"Knowledge is power." - Francis Bacon

The ESRB does not have binding power, it is merely able to issue warnings and recommendations, which may be public if it does not affect the risk situation (Regulation 1092/2010, Article 16). These can be directed generally towards the EU or to a specific member state, ESA or national supervisory authority. The addresee of such action has to communicate the actions undertaken. If the recommendation is not implemented the ESRB may choose to forward the issue to the Council. The same 'act or explain' mechanisms is also in place in the USA with a fixed period of reply being 90 days (Dodd-Frank Act, section 120, (c) (2)) with respect to the development of prudential standards directed towards the CFTC or SEC. Such recommendations may e.g. take the form of recommending resolution plans, credit exposure reports, concentration limits, enhanced contingent capital, public disclosure and short-term debt limits. (section 115, (c)-(g)). Furthermore individual companies (identified by the FSOC under section 804) can be subject to mitigatory action allowing measures such as the restriction on mergers and on offering financial products (section 121). If the FSOC's recommendations are not implemented the Fed may decide by a two-thirds majority to make the recommendation binding.

Firstly it is striking here that the period of reply is very different. In the USA addresees have 90 days to reply, whereas in the EU half a year up to one year is usual. The other feature is, that the possible addressees are different. In the EU a large variety of national and EU-level agencies can be addressed. In the USA on the other hand just federal agencies can be addressed in the public sector, but also individual firms can be put on the agenda. This relates to the mandate of each body, as explained in the previous section. Since the USA's focus is more on SIFIs, their regulatory body also has more powers to address single market institutions, whereas in the EU this power is still held by the member states, since it is assumed – as argued above probably correctly - that these powers are better positioned at the member state level, which is also why the inclusion of the lower levels of governance are so important. The shorter reply period on the one hand is connected to the different way of making decisions and handling business contacts in the public sphere. On the other hand the EU suffers from an organizational disadvantage since the recommendations and the following communication has to be for example translated and representation is dispersed.

The value of a 'act or explain' mechanism lies in the idea, that the opinion of the board is so highly esteemed that its recommendations are followed. Nyberg (2011) sees the mechanism as a powerful tool and able to provide an independent opinion with possibly the ability to push for politically inconvenient measure. Thus it is important also to look at actual practice following a recommendation. Since both bodies have only been established recently the cases are very limited.

In the EU six public recommendations have been issued. Each recommendation is accompanied by a deadline until when a report with the implementation and justifications for possible inaction are to be included. For the first one (foreign currency lending) the final deadline was december 2012. On the ESRB page the reactions of the member states can not be retrieved in a summarized fashion. With respect to the first recommendation concerning the lending in foreign currencies reactions of eight countries (and not of the EBA) are found publicly containing mixed reactions (see Annex for details). This point especially diminishes the claims about making the warnings public, since information about it is scarce until now. Concerning the national mandates only two countries fully complied with the recommendations by September 2012, which is considerably after the interim report in june 2012 (Panetta, 2013). Thus no definite answer can be given to whether or not the ESRB's recommendations are actually followed, but the case for strong compliance seems rather vague until now.

The FSOC was confronted with the same scepticism towards the effectiveness of its recommendations (Abernathy 2012). The actions, which the FSOC can perform are more various, but it has the same recommendation mechanism in place. The duties of the council include the recommendations to financial authorities and the designation of systemic importance to individual institutions. For the FSOC we look at a proposal on money market funds, issued in November 2012 and directed towards the SEC. The proposal within the FSOC stemmed from a failure within the SEC to vote positively on the issue some months earlier (Gulino and N'Diaye, 2012). The SEC did indeed react on this recommendation of the FSOC positively since it recently issued a proposal to comment open to the public for comments (Rittenhouse, 2013). The developments of the MMF recommendation have been predicted to be a test for the FSOC as to how successful its 'act or explain' mechanism is (Borak, 2013).

Concerning its second duty the FSOC has used it very scarcely, but a very interesting case has developed if compared to the EU. By designating a nonbank insurance company as systemically important the FSOC (FSOC, 2013) undid the previous standard, whereby insurance oversight was done by the states (Gramm-Leach-Bliley Act, Section 1, 1999). Yet this measure was seen as very much needed when considering the role of nonbank financial holdings during the crisis. Thus the FSOC can be seen as not only holding effective power vis-à-vis the federal institutions, but also to be able to pass legislation on issues previously held by the states.

Concluding this part the FSOC strength lies in its effective application of the power given with the 'act or explain' mechanism. Whether the ESRB will be able to act with the same strength has to be established with its further track record. Until now little convincing evidence can be found, that it develops in the same kind of powerful institution.

6.2. Institutional design

The second step is to investigate in how far the institutional set-up is centralized according to the indicators in table 6. For this part also the internal working structures set up by the committees themselves and the reports of the daily business of the agencies are used.

Table 6: Indicators for a centralized system

1. Vertical division of power
2. Unitary/federal system
3. Accountability
4. Single/Shared external representation

6.2.1 Vertical division of power

The question that has to be asked here is the degree of involvement of the central bank. In the EU the ECB modelled after the German central bank is very independent, whereas the US is on the more middle spectrum of independence. (Lijphart, 2012) In the USA the Fed holds one of the ten votes in the FSOC. In the EU the situation is a bit more complicated, since the general council format is dominated by the member states with the central bank holding two out of the 37 votes. In the steering committee on the other hand the central bank holds two out of 14 votes, which is more than in the USA. These are the direct links, but measuring the balance of political and central bank power is more complicated since also the supervisory institutions can be seen as independent bodies acting under a technical mandate.

If we see the supervisory institutions as such bodies technical reasoning is definitely in the majority in the USA, whereas in the EU the picture is mixed. In the steering committee fifty percent of the votes are supposed to follow technical reasoning (the chair and vice chair of the ECB, the ESAs and the advisory committees). In the general board the situation is even more complex due to a two-thirds quorum (Art. 10, Regulation 192/2010) and the involvement of central banks, which dominate the scene, whereas it is difficult to establish, whether they follow national or technical reasoning (27 voting members plus one from the Commission). In general European central banks belong to the most independent ones in the world, but the variation is very strong (Lijphart, 2012). Furthermore when looking at the mandates of the national central banks their commitment is of course primarily rested on the stability of the national financial system. Thus it remains questionable to say the least, whether the central banks will adopt a less politicized approach to the issues.

Therefore one can state in conclusion that the European approach is more politicized as could be expected from an international institution. With respect to centralization therefore the USA is more integrated than the EU due to the stronger features of its legal system, but also the larger share of federal representatives on the final decision making body.

6.2.2 Unitary/federal system

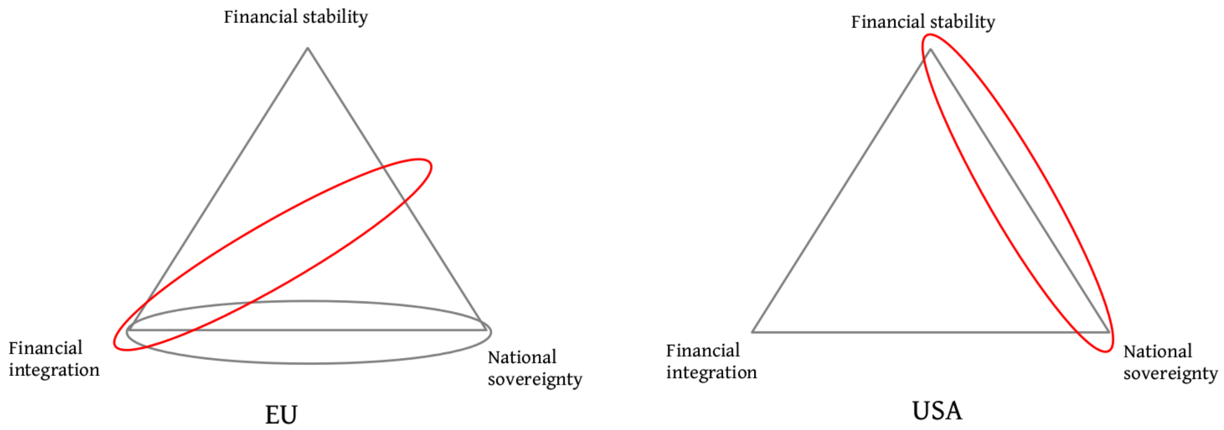
There was a widespread feeling that supervisors in many countries could not see the wood for the trees – and certainly not any woods in any other countries. - Lars Nyberg

In both the EU and the USA supervision is subject to a dual system with federal (or EU level) and state rules, whereby the former takes precedence over the latter. This regulatory competition is a common system for the USA and also has become more common for European legislation. It refers to the idea, that state and federal government can adopt legislation, of which the more specific and demanding one prevails. Since in the USA federal law in general prevails over state law in case of conflict the USA system is more centralized. In the EU financial stability is a shared competence. In most cases the principle of sincere cooperation (Art. 4 (3) TEU) is applied, which states that in general EU rules takes precedence unless provided otherwise. There has not been a case before the ECJ to give a definite answer on whether the EU has enough competence to demand compliance by its member states in general. But due to the nature of financial contagion the principle of effectiveness demands that such competence is given to the Union.

The involvement of the national agencies is a lot more express in the set-up of the ESRB since the governors of the central banks of the member states have voting capacity and the national supervisory authorities are present at meetings. This set-up is possible due to the two meeting formats of the ESRB. If one compares the steering committee of the ESRB and the FSOC the membership seems more or less the same mixture of functional and national representatives. But for the ESRB the steering committee has more of a gate-keeping function since it sets the agenda for the meetings of the general board, where the central banks of the member states have a predominant role (27 voting members). In general the ESRB bodies (14 and 37 voting members) are larger in size than the FOSC (10 voting members). Nyberg (2011) describes the ESRB in terms of the model developed by Schoenmaker (2011) as an intermediate solution between a federal approach and full member states control. The FSOC with its predominantly federal approach can be described with the right hand model in picture 6. One of the biggest problems in safeguarding financial stability is the spread of information through the supervisory system. Whether or not more participants are beneficial for the process will have to be investigated in future.

As one can also read in Picture 6 it was thought that even with financial integration and national sovereignty (as in the pre-crisis supervision in Europe) financial stability can be achieved. As pointed out in the De Larosiere Report (2009) the deficits of this structure were revealed during the crisis and the set-up moved more towards more supranationalism. But this structure is dependent on the amount of financial integration present. As shown by Schoenmaker and van Laecke (2006) Europe is financially a lot more integrated, but not only regionally as one would expect but to the same extent also globally. Integration in the bank market of the USA on the regional and global level is less pronounced, thus the management of financial stability within national sovereignty is still possible. Although due to globalization and the dispersion of capital across borders this view is probably exaggerating the degree of autonomy the USA has in its safeguarding of financial stability.

Picture 6: The relation between financial stability, integration and national sovereignty



adopted from Schoenmaker (2011c) and Nyberg (2011) with the red lines representing the post crisis institutional set-up.

Another explanation can be found in the more consensus-seeking culture in the EU political system, than in the one of the USA (Lijphart, 2012). The EU is depicted as the near-perfect model for a consensus democracy and this also fits to its description as a quasi-federal state. In the USA the different states, the OCC, the Federal Reserve or a combination depending on the choice of the bank as to which charter it adopts can carry out the supervision. Financial supervision at the state level is quite minimal since mostly supervision is done at the federal level for banks having systemic relevance for the whole US. In the EU the home member state principle, which also holds for the truly international case, is applied with the ESRB as addition. Thus nationally significant banks are supervised at the state level and if they become systemically relevant for the whole EU the ESRB also has the task to determine its risk for the financial system.

Concluding therefore we can state, that the EU is less centralized than the USA with respect to the supervision of the whole financial system. This holds especially with respect to SIFIs, which are not at all under central supervision in the EU as long as they are just nationally relevant. But also the general approach of the ESRB is more dominated by national interest.

6.2.3 Accountability

As explained earlier there are valid reasons, why a regulatory agency may choose not to make warnings public. In both the EU and the USA the data on the basis of which the warnings are concluded are to be held confidential (USA: section 116 (b) (3), EU: Art. 15). In the EU warnings and recommendations are made public upon decision by the ESRB on a case by case basis. (Art. 18, Regulation 109272010). Since the USA can supervise both government agencies and companies two procedures for accountability have been developed. With respect to companies a hearing is to be requested within 30 days from the receipt of notice to contest the action taken (section 113, (e) (2)). In the US legislation the possibility for judicial review is also explicitly stated in section 113 (h). In case a recommendation on regulatory standards is made a report to congress is to be prepared (section 120 (d)).

The FSOC has a hearing presenting its annual report once a year before the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate (section 112 (c)). Furthermore it is subject to a GAO Audit und section 122 of the Dodd-Frank Act. The ESRB firstly has annual hearings before the European Parliament to present its report. Secondly there are also confidential oral meetings before ECON Committee twice a year. (Art. 19, Regulation 109272010) Thus one can conclude that the accountability procedures before the government institutions are of equal strength. Besides these reporting duties the two agencies differ in the degree of accountability they owe to the public. In the USA the minutes of the meetings are published, whereas in the EU meetings are held behind closed doors. This secrecy can be seen under the same justification as in the Council of the EU, where it is used to promote openness and ease issues of national sovereignty. Yet also the Preseident of the ECB Jean-Claude Trichet recognizes the importance of transparency for financial stability (Trichet, 2009).

It results though that the EU is less transparent and accountable to the public than the USA, one also has to mention though that it faces larger difficulties in this respect and different structures are common to the EU due to it being an international cooperation. The member states governments are far more responsible for representing the will of the people in the general legislative process than the state governments in the USA.

6.2.4 Single/Shared external representation

The external dimension of the EU is in general quite weak if compared with a nation state such as the USA. Especially the larger member states have not been willing to give up representative power on the expense of a strengthened EU. Thus a hybrid system of dual representation has emerged in many areas of policy making among which financial stability. For the USA and the member states of the EU the central bank (Board of Governors of the Fed), the financial supervisory body (the SEC) and the finance minstery (the department of treasury) is usually part of the negotiations at the FSB. The EU coordinates the position of its member states and takes part with representatives from the Commission and the ECB. This is especially relevant since just seven EU members are represented separately and the 20 member states left have to voice their opinion through the Commission. Through this distinction a discrimination of power between represented and not represented states emerged. This is thus a motivation for the latter to push for a general European level representation.

Given that the EU is merely an international organization the scale of centralized power is indeed impressive, yet if compared to the USA, which can draw on its federal institutions, the scale of cooperation is less extensive.

7. CONCLUSION

> *"The world will not evolve past its current state of crisis by using the same thinking that created the situation." - Albert Einstein*

With respect to the two models of defining financial stability, the EU tends towards defining financial stability via the absence of a crisis. On the one hand shocks and exposure have to reach significant levels until they are recognized as a period of financial distress. On the other hand the efficiency of the financial market as contributing to the economic system is recognized as a goal. The USA puts a larger emphasis on SIFIs, but does not include efficiency in the objectives for the newly established agency. The level of significance is low as indicated by using 'emerging threat' as a threshold to prevent a crisis. Thus the FSOC is hypothesized to posses a stronger and more centralized mandate in comparison with the ESRB.

Both countries set out an explicit dual mandate (with monetary policy being more important) for their supervisory institutions after the crisis, but the approach taken inside these mandates is different. The focus in the USA lies more on SIFIs and thus establishes a direct capacity for the agency to supervise their risk taking behaviour. This is mirrored in the FSOC's ability to ask for information disclosure and its policy options such as recommendations directed towards the private sector. Furthermore the FSOC can label financial institutions as systemically important and place them under special supervision. The ESRB on the other hand is less concerned with the supervision of SIFIs, which can be explained by the structure of the financial market. In the EU there are various national SIFIs, which of course can be according to the principle of subsidiarity best supervised by their respective national agency since it already has established links with the company. Futhermore these agencies are not subject to structural disadvantages such as language, from which the EU institutions would suffer. The main task of the ESRB is to supervise risk, which could emerge due to the integration of financial markets. Therefore it also can just request aggregated information and the possible addresees are solely within the public realm. The definition of a bank holding is approximately the same in both pieces of legislation, the only difference is though that the qualifying holding for a nonbank financial company is 10% in the EU an 25% in the USA. Thus concluding this part we can say that the EU has a weaker mandate, confirming the hypothesis.

The distribution of votes in the formats of the ESRB follows a process typical for the EU. The gate-keeper function is assumed by a more technical committee and the general format, which takes the final decisions is dominated by the member state's opinion. The external representation is thus also dual, so that important member states can voice their opinion separately. In the USA the committee is of purely technical nature and the sole representative. Both the EU and the USA have a federal system of regulation, whereby the EU puts less emphasis on the national sovereignty with the establishment of the ESRB. Therefore the USA has as stated by the hypothesis a more centralized mandate. Lastly also the external dimension is more centralized in the USA. This thus also shows in the length of their financial stability reports (as predicted by Cihak, 2007) with the FSOC producing an average of 147 pages whereby the ESRB 2011 annual report just had 35 pages.

Table 5: Similarities and differences of the regulatory agencies

Similarities	The FSOC also can
Dual mandate	Request disaggregated company data without justification
No direct authority to request information	Recommend to the private banking sector
Act or explain mechanism	Demand a reply within 90 days (compare 1-1,5 years)
Definition of a bank	Solely represent at the FSB
Federal system with regulatory competition	
Annual hearings before the legislature	

The question remains what does this mean for the understandings of financial stability in the EU and the USA. Although the general structures are different as well as the main objective of the boards to pursue when ensuring financial stability several points also were quite similar as can be seen in Table 5. The Dodd-Frank act was passed before the Regulation 1092/2010 indicating that the EU adopted principles of the US legislation. The problem here is that in the European system some approaches might not work as well as in the American political system. One example, which is crucial for the working of the committee is the 'act or explain' mechanism, which is built on 'name and shame' journalism to pick up the holes in the system. But since media coverage is less and the big European banks are mainly national this discussion is not conducted as well in the European political system. Furthermore the FSOC is equipped with further information inquiry powers and smaller in size, which might make it more effective. In the EU issues of sovereignty often precede issues of effectiveness, which also might hinder the success of the ESRB. These findings are especially interesting when seen in the light of other European approaches such as the European Resolution Authority and the European Banking Insurance Scheme currently under discussion. If the EU was to adopt such a measures it would move more and more towards the stable system model of financial stability, thereby equaling the USA in the strength of their mandate and also enabling the ESRB to conduct its work easier.

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APPENDIX

1. Table of abbreviations

ASC	Advisory Scientific Committee (to the ESRB)
ATC	Advisory Technical Committee (to the ESRB)
BIS	Bank of International Settlements
CFTC	Commodities Futures Trading Commission (USA)
ECB	European Central Bank
ECJ	European Court of Justice
ECON	Economic and Monetary Affairs Committee to the European Parliament
EU	European Union
ESA	European Supervisory Agency
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
FSOC	Financial Stability Oversight Council
GAO	Government Accountability Office of the USA
OECD	Organization for Economic Development
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission (USA)
SIFI	Systemically Important Financial Institution
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
USA	United States of America
WTO	World Trade Organization

2. Objectives of the Dodd-Frank Act and Regulation 1092/2010

SEC. 112. COUNCIL AUTHORITY.
(a) PURPOSES AND DUTIES OF THE COUNCIL.—
(1) IN GENERAL.—The purposes of the Council are—
(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
(B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
(C) to respond to emerging threats to the stability of the United States financial system.
(2) DUTIES.—The Council shall, in accordance with this title—
(A) collect information from member agencies, other Federal and State financial regulatory agencies, the Federal Insurance Office and, if necessary to assess risks to the United States financial system, direct the Office of Financial Research to collect information from bank holding companies and nonbank financial companies;
(B) provide direction to, and request data and analyses from, the Office of Financial Research to support the work of the Council;
(C) monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;
(D) to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;
(E) facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions;
(F) recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies;
(G) identify gaps in regulation that could pose risks to the financial stability of the United States;
(H) require supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure, or because of their activities pursuant to section 113;
(I) make recommendations to the Board of Governors concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors;
(J) identify systemically important financial market utilities and payment, clearing, and settlement activities (as that term is defined in title VIII);
(K) make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets;
(L) review and, as appropriate, may submit comments to the Commission and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure;
(M) provide a forum for—
(i) discussion and analysis of emerging market developments and financial regulatory issues; and

(ii) resolution of jurisdictional disputes among the members of the Council; and
(N) annually report to and testify before Congress on—
(i) the activities of the Council;
(ii) significant financial market and regulatory developments, including insurance and accounting regulations and standards, along with an assessment of those developments on the stability of the financial system;
(iii) potential emerging threats to the financial stability of the United States;
(iv) all determinations made under section 113 or title VIII, and the basis for such determinations;
(v) all recommendations made under section 119 and the result of such recommendations; and
(vi) recommendations—
(I) to enhance the integrity, efficiency, competitiveness, and stability of United States financial markets;
(II) to promote market discipline; and
(III) to maintain investor confidence.

2. For the purposes of paragraph 1, the ESRB shall carry out the following tasks:

(a) determining and/or collecting and analysing all the relevant and necessary information, for the purposes of achieving the objectives described in paragraph 1;

(b) identifying and prioritising systemic risks;

(c) issuing warnings where such systemic risks are deemed to be significant and, where appropriate, making those warnings public;

(d) issuing recommendations for remedial action in response to the risks identified and, where appropriate, making those recommendations public;

(e) when the ESRB determines that an emergency situation may arise pursuant to Article 18 of Regulation (EU) No 1093/2010, of Regulation (EU) No 1094/2010 and of Regulation (EU) No 1095/2010 issuing a confidential warning addressed to the Council and providing the Council with an assessment of the situation, in order to enable the Council to assess the need to adopt a decision addressed to the ESAs determining the existence of an emergency situation;

(f) monitoring the recommendations; follow-up to warnings and

(g) cooperating closely with all the other parties to the ESFS; where appropriate, providing the ESAs with the information on systemic risks required for the performance of their tasks; and, in particular, in collaboration with the ESAs, developing a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk;

(h) participating, where appropriate, in the Joint Committee;

(i)coordinating its actions with those of international financial organisations, particularly the IMF and the FSB as well as the relevant bodies in third countries on matters related to macro-prudential oversight;

(j) carrying out other related tasks as specified in Union legislation.

3. Table of countries with references to ESRB recommendations

Austria	http://www.bancaditalia.it/vigilanza/analisi-sistema/ESRB/misure-attuate/FMA-FXTT-MS_EN_FINAL.pdf
Bulgaria	http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/anual_report_2011_en.pdf
Germany	http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2013/fa_bj_2013_03_marisk_ba_en.html
Malta	http://www.bancaditalia.it/vigilanza/analisi-sistema/ESRB/misure-attuate/Malta-FSA-FX-Lending-Rule.pdf
Poland	http://www.nbp.pl/homen.aspx?f=/en/aktualnosci/2012/esrb_en.html
Romania	http://www.bnro.ro/DocumentInformation.aspx?idDocument=13750&idInfoClass=6877
Sweden	http://www.riksbank.se/Upload/Rapporter/2011/FS_2/FS_2011_2_en_box_1.pdf
United Kingdom	http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1207.pdf