Financial supervision in Europe

Letter (October 2005)

The Monetary Panel of the European League for Economic Cooperation (ELEC) met in Utrecht on October 6th and 7th to consider the cross-border implications of financial supervision in Europe, taking account among others of the recent Commission Green Paper on financial services.

We were privileged to hear presentations by Philip Klopper, Member of the Board of De Nederlandsche Bank and Dirk Schoenmaker of the Dutch Ministry of Finance as well as remarks by John Berrigan, of DG ECFIN.

Though no formal debate resulting in formal recommendations from the Panel ensued, it was felt useful to inform the Commission and the Financial Services Committee of some of the concerns expressed during the discussion.

The Panel noted that the current supervisory arrangements in the EU were called in question on several scores by both the authorities and the industry. The fragmented supervisory landscape is considered by many as an obstacle to further integration of financial markets and may be a contributing factor in explaining the relatively slow trend in cross-border merger and acquisition activity. It was further noted that there was a strong desire expressed by the industry for implementing the concept of a "Lead Supervisor", which would constitute a major step in the streamlining of the regulatory framework. In addition, there are strong calls for the harmonisation of "reporting requirements" which at present impose heavy and unnecessary costs on industry, without yielding additional material insights to regulators.

It was also understood that the Commission and Member States were inclined to favour an "evolutionary" path relying heavily on an intensification of supervisory cooperation, particularly within and between the three "Level Three" committees established as part of the "Lamfalussy" process. It is assumed that this step-by-step approach would ultimately lead to the emergence of a Union wide supervisory framework. However, this cooperation cannot by itself lead to action having direct legal force. While acknowledging the merits of such an approach and the desire to minimize legislation, the Panel questioned its practical limits.

The importance of further financial integration under efficient supervisory arrangements should be recognised by setting clear targets and deadlines for improving the convergence of supervisory practices, and at the same time, by exploring further the possibility of implementing the concept of "Lead Supervisor", which admittedly still needs further clarification, as the remarks of the Panel set below underscore.

The remarks of the Panel can be classified under three broad categories:

a- The process of harmonisation of rules of supervision applied by the various national authorities as well as of the powers exercised in each country by the various competent bodies.

b- The determination of the "Lead Supervisor" for a particular institution and his relationship with the host supervisors.

c- The apportionment of costs between lenders of last resort in case of failures involving a systemic threat to financial stability.

With regard to the first point, it is clear that the implementation of the concept of "Lead Supervisor" would be greatly eased if all reporting requirements had been previously harmonised, making sure that the home and host supervisors are in possession of comparable data concerning institutions operating in one jurisdiction and supervised in an other. While many argued this should be a prerequisite, it was also pointed out that it is part of the "Lead Supervisor" concept that the Lead Supervisor defines the reporting formats and is the only point of contact for the firm: one would only need to make sure that the host supervisor has appropriate data to assess financial stability. Clearly, however, a disparity of reporting formats as between different lead supervisors would have to be monitored and preferably eliminated over time.

A further concern - which incidentally applies irrespective of deliberations on the lead supervisory model - pertains to the variety in status, powers and scope of the various regulatory bodies competent for financial supervision in the Member States. It is feared that a simple process of coordination between existing authorities will not deliver the required framework unless all supervisors enjoy comparable/equal powers and unless national laws are suitably amended to avoid jurisdictional conflicts. Moreover, many of the advantages of introducing a lead supervisor would be lost if the latter was not endowed with the necessary enforcement powers which by definition imply a cross-border jurisdictional empowerment. For these reasons, and despite the difficulties, a European Union regulatory framework may prove unavoidable in this area.

With regard to the appointment of the "Lead Supervisor" for any particular firm, it was understood that building on existing rules would logically lead to selecting the supervisor of the country where the parent company has its legal seat. There was ground, however, for considering this issue more carefully:

a- the country of incorporation may differ from the country where the company carries the major weight of operations, or in which risk management is being centralised. The possibility of using the European Company Statute might give particular relevance to this issue;

b- the choice of supervisor might play a significant role in the field of competition, to the extent that, at the present time, the standards of competence vary widely, not only between Member States, but also between authorities competent for supervising either banking, insurance or both in a given country. Consumer confidence in the supervisor will be an essential ingredient in an institution's ability to operate;

c- the automatic selection of the "Lead Supervisor" on the basis of the home country of the institution may pose particular problems with regard to some countries, notably those admitted in the most recent enlargement of the Union. Indeed, in some of these countries, a majority of banking institutions have passed under foreign control. While this development was certainly positive in accelerating the process of financial market integration and bringing in appropriate operating standards, the implementation of the "Lead Supervisor" concept would leave a number of local supervisors without any significant "raison d'être";

d- the choice of a "substantive" rather than "legal" criterion to select the "Lead Supervisor" would by no means be free of problems: for instance, should one consider the size of the balance sheet of the various entities operating in different Member States as the determining factor? Would then a cross-border merger involving a shift in the relative importance of existing operations entail a corresponding shift in the lead supervisory function?

These various questions were seen as putting a premium on furthering the cooperation between home and host supervisors, perhaps under the umbrella of a "European mandate" for the "Lead Supervisor".

Turning finally to the question of "burden sharing" in case of failures, it was widely believed that finding a solution to this problem was necessary in order that substantive progress be made in implementing an efficient "Lead Supervisor" system.

As in all such questions, the possibility of divorcing, even partially, financial responsibility from control over the intervention process raises questions of shared sovereignty, aggravated by budgetary considerations. Such a divorce of power and responsibility would also create lop-sided incentives, which might distort decision-making.

A related complication lies in the disparity of existing national schemes for protecting depositors. While greater harmonisation in this field is seen as highly desirable, one view was that it might be more promising to seek ways of merging these schemes into a single "European Union Deposit Insurance Corporation".

The remarks here above do not purport to be an exhaustive evaluation of the very complex subject of financial supervision. We hope, however, that they may contribute to highlight some of the questions that need to be addressed if significant progress is to be made in lowering the barriers to free trade and competition within the single market.

ELEC supports financial market integration in Europe and a level playing field for mergers and acquisitions of financial institutions across national borders. Against this background, ELEC will continue to monitor closely developments in the field of lead supervision and would be willing to bring any support and/or advice to the Commission as seen appropriate.

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