CAHIER COMTE BOËL

n° 12: February, 2006

Financial Supervision in Europe: Do we need a new Architecture?

LIGUE EUROPEENNE DE COOPERATION ECONOMIQUE
EUROPEAN LEAGUE FOR ECONOMIC COOPERATION

FOREWORD

The League has a long standing record of monitoring and encouraging progress in the various dimensions of European integration. The publication of a "Cahier Comte Boël" signals that the League has a keen interest in the issue under consideration, that it has devoted resources, time and energy to its discussion and that it wishes to add its contribution, in a forward-looking manner, to the expected policy action in the field.

This new "Cahier" is intended to serve that very purpose in connection with the hotly discussed subject of the future of financial supervision in Europe. It is hoped that all interested parties, be they subject to supervision, or involved on the side of supervisors, or interested in the public debate on that issue, will in due time give proper attention to the proposal made in this "Cahier", as well as to the points raised in connection with its discussion.

The idea and the substance of the "Cahier" arose from a meeting of the Monetary Panel of the League, held in Utrecht in October 2005. While neither the League nor its members are committed to endorse the views expressed in the "Cahier", which remain the responsibility of the authors, it was felt that the debate was adding value to the current wave of "brain storming" on the issue and therefore deserved publication in this form.

Anton van Rossum
International President

Jean-Claude Koeune
Secretary General

What is ELEC?

The European League for Economic Co-operation is a non-governmental and non-party organisation that aims to promote the economic integration and socio-cultural identity of Europe, and to enhance Europe's role in the world. ELEC was created in 1946-47 by a group of influential policy-makers who, even then, were involved in a process of reflection aimed at paving the way for a Europe that would be federated politically, economically and culturally. The majority of ELEC members come from banking, business, scientific circles or high-level administration. So they are ideal observers of the full spectrum of events unfolding in Europe and some participate in the European decision-making process.

Background on ELEC: http://www.elec.easynet.be/A1desc_E.htm

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INTRODUCTION

As financial integration proceeds in Europe, admittedly at unequal speed depending on products, markets and institutions, the adequacy of the current framework for financial supervision is increasingly called into question.

Coordination or centralisation: These seem to be the key words in seeking alternative solutions to this problem. However, coordination is felt by some to be slow and cumbersome, while centralisation is seen by others as wasteful and premature. To state that the problem is a complex one is a huge understatement.

After reviewing the progress made in implementing the Financial Services Action Plan, the Monetary Panel of the European League for Economic Cooperation decided to give particular attention to this issue, focusing in particular on banking and on the concept of "lead supervisor", as promoted among others by the European Roundtable for Financial Services. On October 7, 2005, the Panel held a meeting in Utrecht, at the invitation of Rabobank, and had a full day of discussion on the subject, on the basis of a presentation by Dirk Schoenmaker, Professor of Finance, Banking and Insurance at the Vrije Universiteit Amsterdam and Deputy Director Financial Markets Policy at the Netherlands Ministry of Finance.

The merits of the approach by Dirk Schoenmaker are several. He combines the theoretical background with practical experience in supervision and an empirical analysis of cross-border integration in banking and insurance. He is not prisoner of the coordination versus centralisation dilemma, but builds on the comparative advantage of both models, taking account of the diversity of the financial landscape throughout Europe. He does not outline a once and for all solution, but suggests a framework which can smoothly adapt to the changing reality of financial integration.

The Panel felt it worthwhile to share the benefit of its deliberations with a wider audience, while Dirk Schoenmaker offered to write a revised paper, taking account of the discussion. The present "Cahier Boël" is published as a result of this fruitful exchange of views. It is divided in two parts: the first one is the contribution written by Dirk Schoenmaker and Sander Oosterloo, while the second part includes comments by Graham Bishop and Marianne Kager on some issues which would predictably accompany the endeavour to implement the proposed scheme.

It is hoped that the Cahier will be read as a helpful addition to the ongoing debate. I believe the authors deserve praise and gratefulness for the clarity and depth of the views expressed. A particular tribute should be paid to Graham Bishop who acted as co-ordinator for the project.

Jean-Jacques Rey
Chairman of the Monetary Panel

The Monetary Panel is always pleased to expand its expertise and welcomes new members who wish to participate in this type of debate. *Contact the Secretary-General*

Part I : Financial Supervision in Europe: Do We Need a New Architecture?[1]

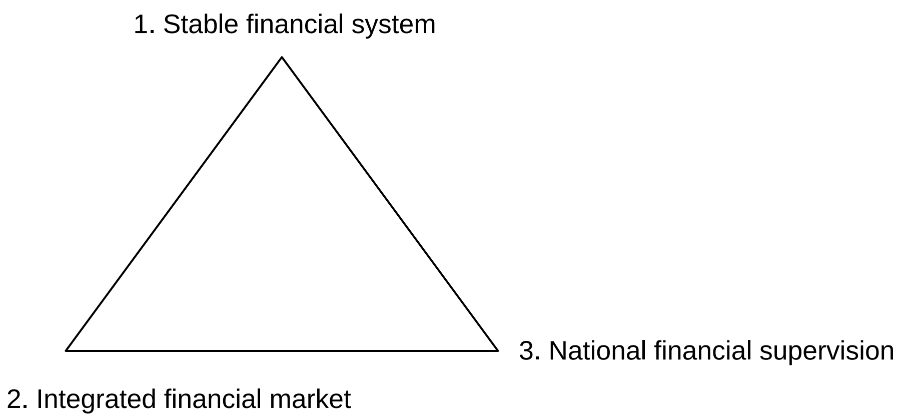
Dirk Schoenmaker and Sander Oosterloo[2]

1. Introduction

After the successful establishment of the EMU, the debate on the need for a ‘European System of Financial Supervisors’ is intensifying in the literature (e.g. Vives, 2001; Schoenmaker and Oosterloo, 2005) as well as in the policy arena (e.g. EFC, 2002; CESR, 2004; FSC, 2005).

The basic argument in favour of moving to a European structure is that it might be difficult to achieve simultaneously a single financial market and stability in the financial system, while preserving a high degree of nationally based supervision and crisis management with only decentralised efforts at harmonisation (Thygesen, 2003). This is an application of the classical trilemma in macro-economic policy. Policy-makers are confronted with three desirable, yet contradictory, objectives: fixed exchange rates, capital mobility and independent monetary policy. Only two out of the three objectives are mutually consistent, leaving policy-makers with the decision which one they wish to give up: the ‘trilemma’ (Rose, 1996). Figure 1 illustrates the three incompatible objectives in our case: 1. a stable financial system; 2. an integrated financial market; and 3. independent national financial supervision and crisis management. An argument against moving to a European solution for financial supervision at the present time could be that the degree of integration in financial markets does not yet justify such a move.

Figure 1. The trilemma in financial supervision



The paper starts with identifying the trends in the European financial landscape. The first trend is centralisation of risk management functions at the head-quarters of financial groups. This reinforces the role of the home supervisor as the consolidating supervisor. The second trend is increasing cross-border penetration of banks (and insurers). Emerging pan-European banks give

[1] We would like to thank the members of the Monetary Panel of the European League for Economic Co-operation (ELEC), as well as Jean-Victor Louis, René Smits and Bernhard Speyer for their helpful suggestions and comments.
[2] [2] Dirk Schoenmaker is Professor of Finance, Banking & Insurance at the Vrije Universiteit Amsterdam and Deputy Director Financial Markets Policy at the Netherlands Ministry of Finance. Sander Oosterloo is economist at the Financial Markets Policy Department at the Netherlands Ministry of Finance and Ph.D. student at the University of Groningen.

rise to cross-border externalities arising from the (potential) failure of these banks. The increasing presence of banks from other EU countries undermines the capacity of host authorities to manage effectively the stability of their financial system.

To create an Internal Market for financial services, regulations are based on a European footing to ensure their effectiveness as well as a European level playing field. However, supervisory authorities, who enforce these regulations, are still nationally rooted with some elements of European coordination. The national base of supervisors is related to political sovereignty (Herring and Litan, 1994). In a more practical sense, it is also related to the issue of jurisdiction. One needs a jurisdiction for enforcement of regulations, liquidation and winding-up procedures and taxation. As a European jurisdiction is (or can be made) available, policy-makers have the choice to organise financial supervision and crisis management on a national or a European basis. We review the different policy options. Coordination arrangements between national supervisors will cultivate duplication of supervisory efforts by home and host supervisors and multiple reporting by financial groups (Schüler and Heinemann, 2005). In this paper, we propose a prospective European System of Financial Supervisors to be created by a European Financial Authority working in tandem with the national financial supervisors. Key elements are decentralised day-to-day supervision close to financial institutions and centralised policy-making to foster a uniform execution of supervision. Such a European System could combine the advantage of a European framework (to incorporate cross-border effects in the decision-making) with the expertise of national supervisors.

2. Industry developments

Growing cross-border externalities

Both aggregate data and data on individual banking groups suggest that cross-border externalities within the EU have been rising over the last decade. Cross-border interbank loans, for example, account for 30% of total interbank loans in 2005 and the share of cross-border bank holdings of non-bank securities in the total holdings of such securities by banks is more than 45%; in 1997, however, both figures stood at around 20% (Papademos, 2005).

Figure 2 illustrates that cross-border banking within the European Economic Area (EEA) is conducted through branches and subsidiaries. The market share of both vehicles for cross-border banking is quite similar; 8.1% of total domestic assets is from branches of other EEA countries, while 9.0% is from subsidiaries of other EEA countries in 2004.

Figure 2. Cross-border business in the EU (values in € billion; % within brackets)

	2001	2002	2003	2004
1. Total assets of credit institutions	24,686	25,296	26,462	29,010
2. Total assets of domestic credit institutions	18,801 (76.2%)	19.529 (77.2%)	20.305 (76.7%)	21.873 (75.4%)
3. Total assets from EEA countries	3,914 (15.9%)	3,920 (15.5%)	4,062 (15.4%)	4,953 (17.1%)
3a. Total assets of branches from EEA countries	*2,034 (8.2%)*	*1.951 (7.7%)*	*2.013 (7.6%)*	*2.352 (8.1%)*
3b. Total assets of subsidiaries from EEA countries	*1,880 (7.6%)*	*1.969 (7.8%)*	*2.049 (7.7%)*	*2.601 (9.0%)*
4. Total assets from third countries	1,971 (8.0%)	1.847 (7.3%)	2.095 (7.9%)	2.185 (7.5%)
4a. Total assets of branches from third countries	*1,384 (5.6%)*	*1.282 (5.1%)*	*1.273 (4.8%)*	*1.304 (4.5%)*
4b. Total assets of subsidiaries from third countries	*587 (2.4%)*	*565 (2.2%)*	*822 (3.1%)*	*881 (3.0%)*

Source: EU Banking Structures, ECB, 2005.

Figure 3 gives an overview of the cross-border penetration of banking assets in the EU for the period from 1997 until 2004. The first years (1997-1999) cover only the former EU-15 Member States, while the later years cover all EU Member States. This table illustrates that the average market share of the branches and subsidiaries established by banks from other EEA countries is approximately 13 per cent in 1997 and slowly increases to 17 per cent in 2004. In some countries, the cross-border penetration is substantially larger. In Luxembourg and Ireland the market share of banks from other EEA countries is sizeable (89 per cent and 36 per cent respectively in 2002). In these countries, the presence of assets from EEA banks is primarily driven by a favourable tax regime. In Finland the market share of banks from other EEA countries has also become sizeable, after the merger of Nordbanken (Sweden) and Merita Bank (Finland) into Nordea (with the holding company in Sweden).

The extent of cross-border penetration is greater in the new Member States than in most of the former EU-15 Member States. Eight out of the ten new Member States have a banking system in which approximately 40% or more of the banking assets are in the hands of mostly Western-European banks: Czech Republic (87%), Estonia (98%), Hungary (56%), Latvia (39%), Lithuania (74%), Malta (39%), Poland (59%) and Slovakia (88%).

Figure 3. Cross-border penetration of banks: assets (in %)

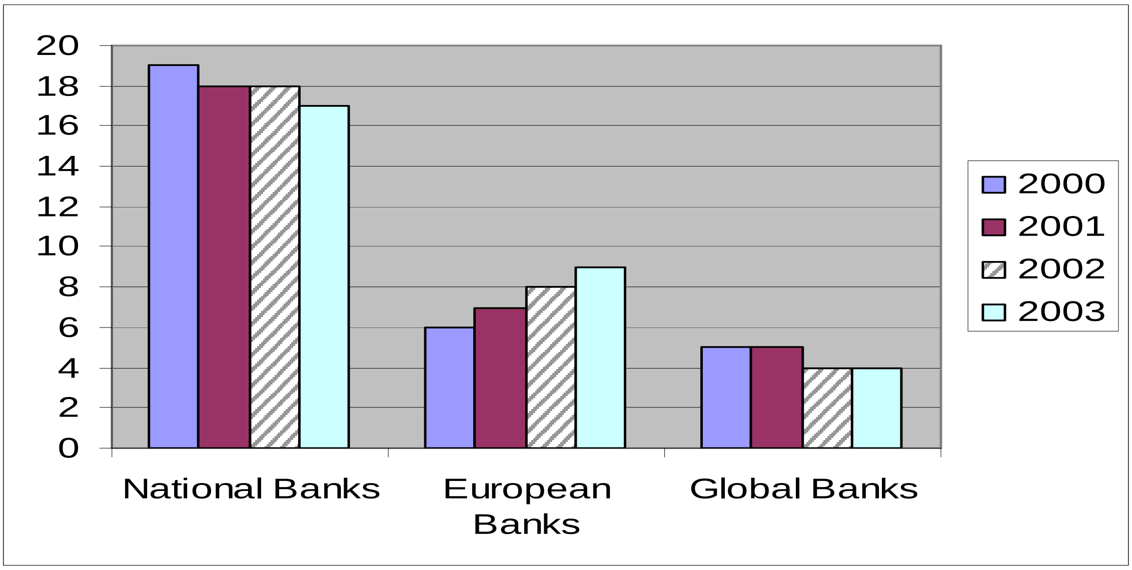
	1997		1999		2001		2002		2003		2004	
Country	**h**	**e**	**h**	**e**	**h**	**e**	**h**	**e**	**h**	**e**	**h**	**e**
Belgium	70	23	76	20	75	23	76	22	76	21	77	21
Czech Rep.	-	-	-	-	28	68	5	90	3	92	8	87
Denmark	96	4	96	4	83	17	82	18	83	17	84	15
Germany	96	2	95	3	95	3	94	5	94	5	94	5
Estonia	-	-	-	-	9	91	10	90	11	89	2	98
Greece	81	11	86	10	91	4	90	6	78	19	75	25
Spain	88	9	91	7	91	8	90	9	89	10	88	11
France	86	7	89	6	86	11	87	11	89	10	89	9
Ireland	46	46	41	50	41	48	51	37	54	35	55	36
Italy	93	6	93	7	95	5	94	5	94	5	94	6
Cyprus	-	-	-	-	77	16	76	17	74	18	70	23
Lativia	-	-	-	-	59	24	63	21	58	22	57	39
Lithuania	-	-	-	-	53	47	44	56	49	51	26	74
Luxembourg	7	83	5	88	5	88	6	89	6	89	6	89
Hungary	-	-	-	-	45	55	47	53	41	56	41	56
Malta	-	-	-	-	29	49	58	42	60	40	61	39
Netherlands	93	5	94	4	89	10	90	9	88	10	88	11
Austria	97	3	97	2	81	19	79	21	80	19	81	19
Poland	-	-	-	-	31	60	31	59	32	59	33	59
Portugal	85	13	85	13	75	24	75	24	74	26	74	25
Slovenia	-	-	-	-	86	14	84	16	82	18	81	19
Slovakia	-	-	-	-	n.a.	n.a.	13	81	11	82	12	88
Finland	92	8	91	9	93	7	91	9	93	7	41	59
Sweden	84	15	69	29	94	6	93	6	92	7	91	8
UK	46	25	48	26	50	25	53	23	50	23	49	26
EU 15	**77**	**13**	**78**	**13**	**77**	**15**	**78**	**15**	**78**	**15**	**76**	**16**
EU 25	**-**	**-**	**-**	**-**	**76**	**16**	**77**	**15**	**77**	**15**	**75**	**17**

Source: ECB (2003, 2005), own calculations.
Notes: New Member States are included from 2001 onwards. Assets from the "Home" country (denoted by *h*) and "Rest of Europe" (denoted by *e*) are measured as a percentage of the total assets of a country's banking system. "Home" is defined as domestic institutions; "Rest of Europe" is defined as branches and subsidiaries from EEA countries exclusive of the home country; "Rest of world" is defined as branches and subsidiaries from non-EEA countries (figures not shown). These three categories add up to 100 per cent. The abbreviation "n.a." means "not available".

Ongoing financial integration fostered by the advance to EMU and the nearly full completion of the Financial Services Action Plan gives rise to increasing cross-border penetration of interbank markets and payment systems, which are important channels for cross-border contagion. Although the vast majority of the 8374 credit institutions in the EU is mainly domestically oriented, pan-European and regional banks are emerging with a sizeable cross-border presence. The 14 largest of these cross-border banking groups already account for almost one-third of total banking assets in the EU (Papademos, 2005). The level of cross-border business of banking groups is an appropriate measure for the cross-border impact of the (potential) failure of these groups ("cross-border externalities"). While there is a consensus that the need for European arrangements ultimately depends on the intensity of cross-border spill-over effects or externalities within the European Union (EU), there has been little or no attempt to measure these cross-border externalities (exceptions are Hartmann, Straetmans and De Vries, 2006; Schoenmaker and Oosterloo, 2005).

Schoenmaker and Oosterloo (2005) have collected a new data-set on cross-border penetration (as a proxy for cross-border externalities) of large banking groups. The top 30 EU banking groups are selected according to Tier 1 capital. The geographical segmentation of the business of these 30 banks is based on the Transnationality Index calculated as an un-weighted average of (i) foreign assets to total assets, (ii) foreign income to total income, and (iii) foreign employment to total employment. The definition of a significant cross-border presence within Europe is twofold. First, a bank conducts more than 50% of its business abroad (outside its home market). Second, a bank conducts more than 25% of its business in the rest of Europe. Figure 4 shows that the internationalisation of the banking sector is increasing. The number of international banks (European and Global banks) increases from 11 in 2000 to 13 in 2003. It is interesting to see that within the group of International banks, the number of European banks increases (from 6 to 9), while the number of Global banks decreases (from 5 to 4). We conclude that the number of banks that have the potential to pose significant cross-border externalities within the European context is substantial and increasing. Within a four year period (2000–2003), a statistically significant upward trend of emerging European banking groups is found.

Figure 4. Classification of top 30 EU banks



Source: Schoenmaker and Oosterloo (2005) based on annual reports 2000-2003.
Notes: National banks conduct more than 50% of business in the home market. International banks (more than 50% of business abroad) are divided into European banks (more than 25% of business in other European countries) and global banks (less than 25% of business in other European countries).

Figure 5 depicts the geographical classification of the premium income of the top 15 European insurance groups in 2004. The top 15 insurance groups is based on the top 15 composed by the Comité Européen des Assurances (2005) and ranked on the basis of total group premium. This table shows that the insurance industry is very internationally oriented. The vast majority of these 15 large insurance groups have an international focus. 10 out of the sample of 15 insurance groups have a significant cross-border presence within Europe (defined as more than 50% of the business out of the home market and more than 25% in the rest of Europe).

This is supported by Van der Zwet (2003), who examines the geographic distribution of revenues of the 38 largest financial groups worldwide in 2000. European financial groups (26 out of the total sample of 38) earn on average 45 per cent of their revenues in their home country, 25 per cent in other European countries and 30 per cent in foreign non-European countries. Van der Zwet (2003) shows that insurance companies are significantly more internationally oriented than banks. Whereas the banks in her world-wide sample have a clear home country bias, insurance companies have a foreign bias. Taken together, the largest financial groups appear to focus equally on home and foreign markets. Furthermore, Van der Zwet (2003) argues that European financial groups are most strongly internationally diversified.

Figure 5. Cross-border penetration by top 15 European insurance firms (in %)

	Total Group Premium (€ million)	Share of home in the group	Share of Europe in the group	Share of rest of the world in the group
Allianz	87,575	31	45	25
Axa	64,924	26	40	34
Generali	56,339	39	57	4
Aviva	44,245	49	43	8
ZFS	42,415	8	51	41
Prudential	23,195	54	2	44
CNP	21,442	96	1	3
Aegon	19,500	19	34	47
Ergo	15,569	82	18	0
Fortis	14,266	39	49	11
Winterthur	13,856	45	42	13
Swiss Life	13,199	44	56	0
Skandia	12,335	21	68	11
Groupama	9,985	81	17	2
Royal/SunAlliance	8,573	52	32	16

Source: Annual reports 2004, and own calculations.
Notes: Share of the home country in the group, share of the rest of Europe in the group and share of the rest of world in the group are measured as a percentage of the total group premium.

Integration of risk management functions

The organisational structure of international financial firms is moving from the traditional country model to a business line model with integration of key management functions. The growing integration and centralisation of management functions, such as risk management, internal controls, treasury operations (including liquidity management and funding), compliance and auditing greatly affect the scope for control of supervisory authorities. One of the most notable advances in risk management is the growing emphasis on developing a firm-wide assessment of risk.

These integrated approaches to risk management aim to ensure a comprehensive and systematic approach to risk-related decisions throughout the financial firm. Although costly to realise, Flannery (1999) argues that once firms have a centralised risk management unit in place, they should expect to reap economies of scale in risk management. Nevertheless, these centralised systems still rely on local branches and subsidiaries for local market data. The potential capital reductions that can be achieved by applying the advanced approaches of the new Basel II framework encourage banking groups to organise their risk management more centrally.

The same could also be true for the future Solvency II framework for the European insurance industry. Drzik (2005) argues that, as insurers consider how to implement new ways to measure and manage their business, they would do well to heed the lessons learned in the banking industry, which has been on a similar path for the last decade. Firms that implement a well constructed risk and capital management framework can derive significant near-term business benefits, and substantially strengthen their medium-term competitive position. The emergence of

Chief Risk Officers at the head-quarters of large insurance groups confirms this trend towards centralisation.

Kuritzkes, Schuermann and Weiner (2003) provide evidence that internationally active financial conglomerates are putting in place centralised risk and capital management units. The dominant approach is to adopt a so-called 'hub and spoke' organisational model. The spokes are responsible for risk management within business lines, while the hub provides centralised oversight of risk and capital at the group level. Activities at the spoke include the credit function within a bank, or the actuarial function within an insurance subsidiary or group, each of which serves as the front-line managers for most trading decision-making.

These managers are familiar with the local conditions such as the business cycle (relevant for credit risk) and the legal and social security framework (relevant for actuarial risk) in a country. Moreover, aggregation across risk factors within a business line also typically takes place in the spokes, often in a finance unit that is responsible for funding and business reporting for the subsidiary. While the hub is dependent on risk reporting from the spokes, in many cases it is also responsible for overseeing the methodology development of an integrated economic capital framework that is then implemented within the spokes.

The specific roles of the hub vary, but tend to include assuming responsibility for group-level risk reporting; participating in decisions about group capital structure, funding practices, and target debt rating; liaising with regulators and rating agencies; advising on major risk transfer transactions, such as collateralised loan obligations and securitisations; and in some institutions, actively managing the balance sheet. A case in point for insurance firms is group-wide asset and liability management done at the head-quarters (hub).

In sum, there is a clear trend to centralise key management functions that previously belonged with the separate entities of a financial group. Centralisation implies that strategic decision-making is transferred from the functional or sectoral entities of the group to the level of the group as a whole (that is, the holding level). The centralisation of activities (such as asset management) and key management functions results from the drive of financial groups to reap the benefits of synergy.

The prospect of cooperation between different entities of a financial group is an important part of the rationale for the group. During this process, the legal structure and the operational structure of the group will increasingly diverge (see, for example, Dermine, 2003; Schoenmaker and Oosterloo, 2006). In consequence, it becomes harder to attribute activities to the legal entities on which the division of supervisory responsibilities is based.

A large difference between the legal structure and organisational structure will complicate the execution of supervision, since supervision is based on statutory power to supervise legal entities (legal structure) and this may not correspond to where activities actually take place (organisational structure). This tension between operationally integrated financial groups looking for synergies and legally constrained supervisors looking for an effective lever on key decision-makers of these financial groups poses a challenge for policy.

3. Does Home Country Control Suffice?

The current system of prudential supervision in the European Union (EU) is based on the principle of home country control combined with minimum standards and mutual recognition. A financial institution is thus authorised and supervised in its home country and can expand throughout the EU (via offering cross-border services to other EU countries or establishing branches in these countries) without additional supervision. The host country has to recognise supervision from the home country authorities.

The arguments for home country control are twofold. First, it promotes the effectiveness of supervision, as the home supervisor is able to make a group-wide assessment of the risk profile and the required capital adequacy of financial institutions (i.e. the concept of consolidated supervision). The concept of consolidated supervision is well established in banking.[3] The recently adopted Directive on Financial Conglomerates introduces a single co-ordinator who is responsible for group-wide supervision of financial conglomerates (in addition to supervision of the separate entities of conglomerates).[4] However, the concept of solo-plus supervision is applied in insurance. The primary focus of supervision is on the separate legal entities (the solo-element) with some limited attention for group-wide supervision (the plus-element).[5]

Second, home country control promotes the efficiency of supervision, as financial institutions are not confronted with different supervisors possibly resulting in duplication of efforts and a higher regulatory burden. Home country control is applicable to financial institutions that offer cross-border services to other EU countries or establish branches in these countries. In practice, however, financial institutions also operate through subsidiaries (separate legal entities) in other countries for reasons of taxation and limited liability.

These subsidiaries are separately licensed and supervised by the host country authorities (*de jure* control). The scope for control by host countries of these subsidiaries is limited in practice, as key-decisions are often taken at the parent company in the home country and the financial health of the subsidiary is closely linked (via intra-group transactions and/or joint branding) to the well-being of the financial group as a whole. The effective control of large financial groups is to some extent in the hands of the consolidating supervisor in the home country (*de facto* control).

While home country control may be useful for the effectiveness and efficiency of prudential supervision, home country authorities are not responsible for the financial stability in host countries (Mayes and Vesala, 2000). Stability of the financial system is the remit of the host country. Increasing integration within the EU gives rise to cross-border spill-over effects or externalities. A failure in one country may cause problems in other countries. **The policy question is whether home country control of supervision,, plus host country responsibility for financial stability is sustainable in an integrating market.**

Summing up, we see two diverging industry trends:

1. Centralisation of risk management functions of large financial groups. This trend reinforces the role of the home supervisor (as consolidating supervisor) to control the group-wide activities of these financial groups;
2. Cross-border penetration by large financial groups (groups head-quartered in one EU countries conducting business in other EU countries). This trend undermines the capacity of host authorities to maintain financial stability in their country.

4. Future policy options

The newly emerging European financial landscape confronts the home and host authorities with complex coordination issues. In the face of these challenges, it is questionable whether cooperation between different national authorities will be an adequate arrangement in an integrating market. As a European jurisdiction is (or can be made) available, policy-makers have the choice to organise financial supervision on a national or a European basis.

The main challenges for a future supervisory framework are twofold:

1. How to deal with integrated financial groups?
2. How to incorporate the cross-border externalities arising from the failure of EU-wide operating financial groups?

While addressing these challenges, an efficient and effective supervisory framework for locally operating financial firms should be kept.

Given the importance of financial conglomerates in the EU, we assume that prudential supervisors operate on a cross-sector basis. Cross-sector supervision can be done by an integrated agency (the FSA model) or by separate agencies for prudential supervision and conduct of business (the

[3] The revised Basle Concordat on international banking supervision introduced the concept of consolidation in 1983. In Europe the concept was adopted in the Consolidated Banking Supervision Directive 92/30/EEC (replaced by the Codified Banking Directive 2000/12/EC).

[4] Financial Conglomerates Directive 2002/87/EC.

[5] Insurance Groups Directive 98/78/EC.

twin peaks model). See Kremers, Schoenmaker and Wierts (2003b) and Schoenmaker (2005) on the different models of cross-sector financial supervision.

On a conceptual level, the most obvious policy options for the structure of financial supervision are:

1. Enhance cooperation between home and host authorities. This can be regarded as maintaining the current supervisory system in the EU. In the current system, the home supervisor is responsible for a financial group and its EU-wide branch network and is the consolidating supervisor as well. The host country is responsible for a group's EU subsidiaries and controls the stability of its financial system. The home and host authorities have to cooperate for financial supervision and stability.
2. Appoint a lead supervisor for prudential supervision of cross-border financial groups. In practice, this will mean that the home country authority of a pan-European financial group is given full responsibility for the EU-wide operations, both branches and subsidiaries.
3. Establish a central agency for prudential supervision of cross-border financial groups at the European level. A central body of some form of European System of Financial Supervisors will be given full responsibility for the EU-wide operations, both branches and subsidiaries, of pan-European financial groups.

Cooperation between home and host countries

In the area of banking supervision, two important policy initiatives have recently been taken to enhance the cooperation between home and host authorities and to strengthen cross-border arrangements for the supervision of large and complex banking groups.

First, the recently adopted Capital Requirements Directive (CRD) introduces an improved legal framework for supervisory cooperation for banking groups with foreign subsidiaries. In particular, the CRD entrusts the consolidating supervisor (i.e. the home supervisor) with co-ordination responsibilities. The consolidating supervisor should (together with the host supervisors) aim at reaching a joint decision on the approval of a bank's internal model. If and when a joint decision cannot be reached within six months, the consolidating supervision can decide.

The CRD also strengthens and clarifies the requirements for information sharing and cooperation between all authorities responsible for the supervision of group entities. This improved framework should promote and facilitate effective supervisory cooperation, especially for large groups that are active in several countries.

Second, the Ecofin Council has adopted proposals to enhance coordination between national supervisors in the EU. The European structure is thus moving from cooperation to coordination with the implementation of the Lamfalussy approach to speed up the regulatory process and to foster supervisory convergence in the EU. A new committee structure was first proposed by Lamfalussy for securities supervision and subsequently implemented. This committee is a form of European coordination between national supervisors. The Ecofin Council has decided to extend the Lamfalussy structure for securities to banking, insurance and financial conglomerates (EFC, 2002). The goal of these new regulatory and supervisory committees is to streamline preparing regulation and to foster supervisory convergence.

It is however questionable whether improved cooperation will end the existing duplication and overlap of supervision. Cross-border expansion through branches can be done without extra supervision (only some minor notification procedures), but subsidiaries in the host country still experience duplication in supervision from the supervisor in the host country and the consolidating supervisor in the home country.

In particular, the new Member States have a large presence of banks from other EU countries. Taking EU-wide figures, the division between branches and subsidiaries for cross-border business is about fifty-fifty (see Figure 2 in this paper and tables 11 and 13 in ECB, 2005). However, the subsidiary form is the primary vehicle for cross-border penetration in new Member States. Host authorities of new Member States have an incentive (as well as a legal basis) to keep on supervising these subsidiaries with EU parents, because of the importance of these subsidiaries for the stability of their financial system.

Efficient supervisory structures are also important for the competitive position of EU financial institutions. A system with duplication by different supervisory authorities with (slightly) different requirements and reporting formats places a high burden on financial institutions and hampers further cross-border expansion within the EU.

As a result European banks may fall behind their counterparts from the US, where the remaining barriers to interstate banking and branching were lifted in 1994.[6] Schüler and Heinemann (2005) have calculated the cost of fragmentation of financial supervision in the former EU-15. Their results indicate increasing economies of scale in supervision.[7] Comparing the current structure with 15 national supervisors with a cost-efficient European supervisory framework, they predict cost savings of some 15%. Although they only calculate the institutional costs of running supervisory agencies, Schüler and Heinemann (2005) suggest that the results could be generalised to other types of supervisory costs, such as the compliance costs of regulated firms (reporting requirements, etc.).

Enhanced cooperation and coordination will also not address the issue of how to deal effectively with integrated financial groups. In this supervisory system home and host authorities work together to maintain financial stability. However, coordination failure is possible during a crisis, as resolving cross-border externalities relies on voluntary cooperation. In line with the allocation of supervisory responsibilities, **the responsibility for decision-making in crisis situations regarding an individual institution and its branches rests with the home country authorities.**

However, home country authorities are not responsible for the financial stability of host countries. Moreover, the home country taxpayer may not be prepared to pay for cross-border spill-over effects of a failure.

The issue of cooperation and loss-sharing has hardly been touched upon in the literature. Freixas (2003) is among the first to explore incentive-compatible mechanisms to allocate the fiscal costs of a possible bail-out among national authorities. He shows that, in the current situation, nationally-based arrangements underestimate the externalities related to the cross-border business of financial institutions. As a result, insufficient capital will be contributed and the financial institution will not be bailed out. Freixas (2003) pinpoints the public good dimension of collective bailout and **shows why improvised cooperation between national authorities will lead to an under-provision of public goods, that is, to an insufficient level of bailouts.**

Lead supervision

According to the European Financial Services Round Table (EFR, 2004) a clearly defined lead supervisor (usually the home supervisor) for prudential supervision of cross-border financial institutions would be an important step towards a more coherent and efficient supervisory framework in the EU. The EFR argues that the lead supervisor should in particular be the single point of contact for all reporting schemes, validate and authorise internal models, approve capital and liquidity allocation, approve cross-border set-up of specific functions and decide about on-site inspections. Furthermore, the lead supervisor should not only be responsible for supervision on a consolidated level, but also on the solo and sub-consolidated level.

The EFR agrees that host countries should be involved in the supervisory process, as local supervisors have generally a better understanding of the local market conditions. The EFR suggests forming colleges of supervisors (one for each specific group) that advise the lead supervisor and discuss proposals of involved local supervisors, but would not have the power to

[6] See Barth, Brumbaugh and Wilcox (2000) for a review of the liberalisation of the US financial system. Though the US supervisory framework is characterised by multiple state and federal supervisors with overlapping jurisdictions, the Federal Financial Institutions Examination Council has developed harmonised reporting requirements, such as the call report (Kremers, Schoenmaker and Wierts, 2003a, p.9).

[7] This is consistent with Goodhart, Schoenmaker and Dasgupta (2002), who also find evidence for economies of scale in supervision.

delay decisions of the lead supervisor. As the role and the powers of the host supervisor in these colleges are non-committal,[8] the actual involvement of host authorities can be limited in practice.

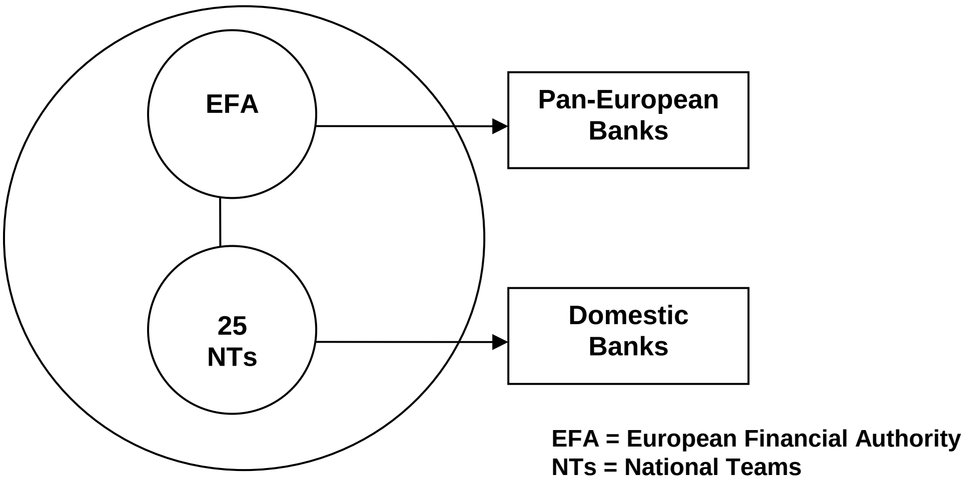
In comparison with the current situation, both the efficiency of supervision and competitiveness of the financial sector are enhanced under this option (responding to the first industry trend). Nevertheless, the lead supervisor does poorly with respect to financial stability, as its national mandate does not induce the lead supervisor to incorporate the cross-border externalities of a failure of a financial institution in its decision-making (not responding to the second industry trend).

In a follow-up report, the EFR (2005) acknowledges the importance of cross-border crisis-management arrangements, such as the lender of last resort and guarantee schemes, to deal with the second industry trend. The EFR suggests a European System of Financial Supervisors (see below) as a medium term option.

<u>Pan-European Supervisor</u>

To respond to the increasing integration within the EU and to have a supervisory system that incorporates the cross-border externalities of a failure of a financial institution, an option is to establish a European System of Financial Supervisors with a European Financial Authority (EFA) at the centre of the system and national supervisors in the different countries. In this context, Breuer (2000, p.9) proposes that “it may also be sensible to have those banking groups that operate on a truly European scale supervised directly by the central agency” (see Figure 6). However, a two-tier system (with a central supervisor and national supervisors) as proposed by Breuer could create an un-level playing field between pan-European banks and domestically oriented banks, while both are competing in the same market.

Figure 6. A Centralised European System of Financial Supervisors: The Breuer Model



Another question that comes to the forefront is related to the appropriate level of (de)centralisation of a putative central agency. Supervision is primarily a micro-policy as day-to-day supervision should be conducted close to supervised institutions (see below). Nevertheless, there may be some merit in centralising policy-making and pooling information, allowing effective market surveillance of European-wide systemic risks. The drawback of a central European supervisor could be that the distance between the central agency and the supervised institutions may be too large – physically and in terms of familiarity with local circumstances.

But would the possible establishment of a pan-European supervisor necessarily result in a predominantly centralised system of supervision? There is a strong case for decentralisation.

[8] In cases of lasting differences of opinion, the EFR proposes to refer cases to the level 3 committees (CEBS, CEIOPS or the Conglomerate Committee), which can either act in an appeal procedure or could organise a mediation process. However, this seems to us a rather bureaucratic process which does not enhance timely decision-making.

First, there are many small and medium-sized financial institutions which operate mainly within national borders. There is no need for involvement at the European level for these institutions. Padoa-Schioppa (1999) draws an interesting picture citing from Italian experience:

1. small banks are supervised by the respective regional branch of Banca d'Italia;
2. national banks are supervised by the respective branches but key-decisions are taken at the headquarters of Banca d'Italia in Rome;
3. pan-European banks are supervised by a group of national supervisors working collectively in a multilateral mode as a single consolidating supervisor.

Second, prudential supervision should be executed at the local level where the financial institutions are based. The use of field inspections is an important tool of prudential supervision. By being close to the coal face, supervisors would get a feeling for what is going on at an institution and would also be more familiar with local market conditions in which an institution is operating. For pan-European financial institutions, the 'lead supervisor' should thus remain located near the head office of the financial institution.[9]

In our view a European System of Financial Supervisors could combine the advantages of a European framework with the expertise of local supervisory bodies (Schoenmaker and Oosterloo, 2006). One could think of a European System of Financial Supervisors with a body at the centre (European Financial Authority) working in tandem with the 25 decentralised national auxiliary branches (see Figure 7). In such a system:

- Small and medium-sized banks which are primarily nationally oriented, are supervised by one of the 25 national teams. In practise not much will change for these banks as they will be supervised by the respective national branch of the European System of Financial Supervisors (ESFS) and there will be no involvement at the European level.

- Pan-European banks are supervised by the consolidating or lead supervisor (usually the supervisory team of the home country). In accordance with the wish of the European Financial Services Roundtable (EFR), this national team will be the single point of contact for all reporting schemes (no reporting to the host authorities), validate and authorise internal models, approve capital and liquidity allocation, approve cross-border set-up of specific functions and decide about on-site inspections.[10]

  With respect to the latter, the lead supervisor can ask host authorities to perform on-site inspections on its behalf. The lead supervisor is compelled to inform host authorities about its activities and host authorities should have access to all reporting schemes (i.e. a common database of the ESFS). In case a host authority feels the lead supervisor does not take account of its interests and no mutual concessions can be reached, it can present its concerns to the Executive Board of the European Financial Authority. An internal committee, consisting of various different nationalities, could then examine those cases and advise the Executive Board. If necessary, the Executive Board can overrule the lead supervisor.

- **Crisis management is also done on a European basis.** While the national team in the home country takes the lead during a crisis at an individual institution (gathering information, making an assessment of the situation), the System is involved to ensure an adequate EU-wide solution. When a crisis hits more (large) financial institutions at the same time, the involvement of the European Financial Authority (in close co-operation with the European Central Bank) will be intensified.

- Key supervisory decisions (for example, the assessment of potential cross-border mergers and acquisitions or crisis management decisions) as well as the design of policy are done at the centre by the Governing Council consisting of the Executive Board and the Chairmen of

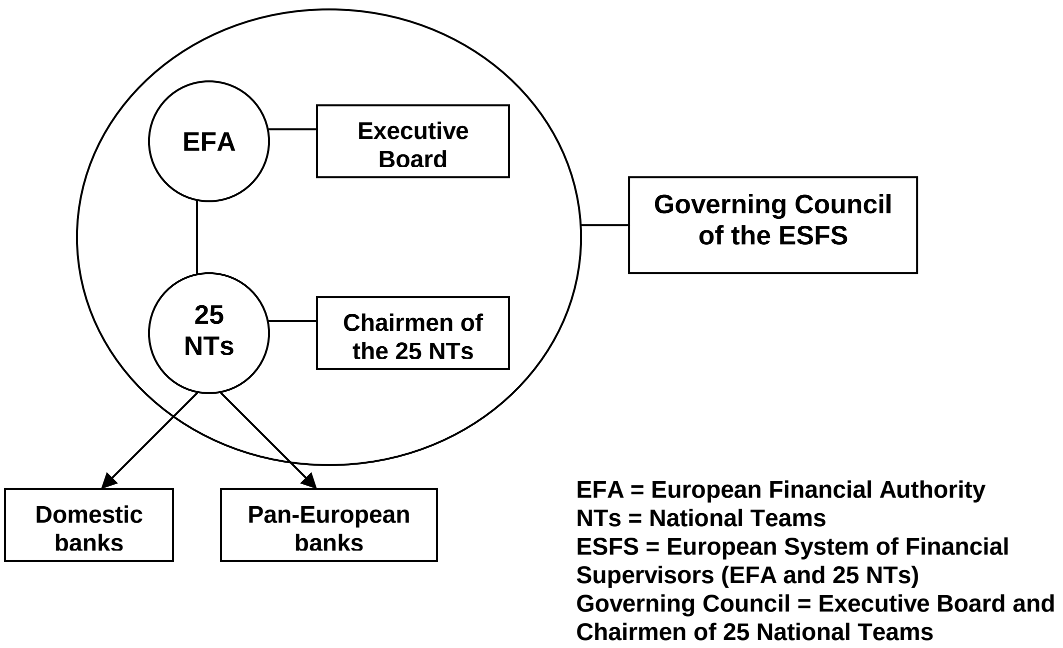
[9] If needed, the lead supervisor could engage local supervisors to visit branches and subsidiaries located in other EU countries, while keeping full responsibility. This would create a team that consists of the lead supervisor in the home country and the supervisors in the host countries.

[10] The EFR (2005, p.43) warns rightly "that the ESFS model could lead to overregulation if it merely added all existing national practices instead of establishing a new, streamlined and efficient system."

the 25 National Teams (in the same way as the ESCB takes decisions on monetary policy).[11] In this way, host country authorities are fully involved and the interests of their depositors are fully taken into account (i.e. potential cross-border externalities are incorporated). Day-to-day supervision is conducted by one of the 25 national teams close to the financial firms. The European Financial Authority (EFA) will be responsible for information pooling and is therefore best equipped to perform EU-wide peer group analysis of large European financial groups. Moreover, the Executive Board is responsible for the correct and uniform application of supervisory rules and it can also act as a mediator in case of problems between home and host countries. In doing so, it may give instructions to the 25 national teams.

- Accountability is an important element of the System. On behalf of the European System of Financial Supervisors, its President will report periodically to the Ecofin Council and the European Parliament. Crucial elements such as the legal basis of the System, the way in which the System will provide information on its activities, and the formal relationship between the System on the one hand and the European Commission, the European Parliament and the Ecofin Council need to be elaborated (see Lastra, 2004 for a good overview). It should be noted that there are similarities and differences between the accountability of central banks and financial supervisors. Whereas for independent central banks there should be no political interference in any case, for financial supervision there should be no interference in individual supervisory cases. On the other hand, political authorities are responsible for an adequate functioning of the financial system and an adequate achievement of the objectives of financial stability and consumer protection. Political authorities therefore retain responsibility for overall policy-making for financial supervision.

Figure 7. A decentralised European System of Financial Supervisors (ESFS)



In order to make this system work, policy rules (e.g. the rulebook and reporting requirements for institutions under supervision) and information pooling (e.g. reporting format and computer systems) need to be made uniform. Such a uniform policy framework would very much be built on the unified regulatory regime established by EU Directives. It can, however, be questioned whether EU Directives are sufficient, because Directives often allow national discretion. In contrast, EU Regulations have a direct application throughout the EU and thus establish a uniform

[11] The efficiency of decision-making is an important issue. If the number of participating NCBs exceeds 15, the governors will vote on a rotating scheme. See Smits (2003) on decision-making in the Governing Council of the ECB.

framework. The introduction of the euro and the application of the IAS in the EU are, for example, done by Regulations to ensure a uniform framework.

Next, appropriate decision-making and incentive mechanisms should be designed to ensure that the national teams adhere to this policy framework. In game-theoretic terms, national teams operate in a repeated game setting. There should, therefore, be sufficient incentives for the lead supervisor to incorporate the interests of host countries to avoid the (embarrassing) possibility to be overruled by the centre (too often). Furthermore, information pooling will allow effective market surveillance of systemic risks by the European Financial Authority (including a peer group analysis of large pan-European financial institutions).

There is also the question whether a European System of Financial Supervisors should continue to build on the existing structure of national supervisors or should be built up from scratch. Anecdotal evidence seems to suggest that one of the reasons for banks' failure to consolidate extensively on a cross-border basis may be partly due to the intervention of national authorities (European Commission, 2005). When building on the existing structure, the existing national biases remain relevant and are most likely to persist. By replacing the existing national structures by a totally new European structure, the risk of national biases could well be restricted.

However, to substitute the existing supervisory structure in the different Member States for another seems to be a very costly operation, which also entails the risk of a drain of local knowledge. Arguments in favour of using existing, but transformed, national authorities are based on experience, expertise and continuity. According to Hartmann (2006) a way in which a European System of Financial Supervisors, based on the principle of subsidiarity, could be made to work is to mix non-nationals of the home country into examination teams. While not strictly comparable, the example of IMF article IV or program missions could provide some lessons. Whatever solution is chosen, there seems to be a clear need for ex ante rules to prevent national biases.

There are two comparative, but differing, examples of creating a European system. The first is the revolutionary option. The role of DG Competition in competition law enforcement started from scratch at the time of the creation of the European Coal and Steel Community (ECSC), because many Member States did not have a competition authority at the time. It is interesting to see that Member States have now established their own competition authorities. This has led to the *ex post* creation of the European Competition Network in 2004 to introduce decentralised elements of competition law enforcement (Smits, 2005). The second is the evolutionary option. As all Member States had a fully functioning central bank at the time, the European System of Central Banks was created on top of the national central banks from the start. It should be noted, however, that Member States had to adjust their Banking Act to ensure full independence (as well as legal convergence) for their central bank as enshrined in the Maastricht Treaty.

Finally, European supervision raises the thorny issue of who should bear the fiscal costs of a possible bail-out. The first-best solution is to keep decision-making on supervision and fiscal bail-outs at the same level. However, there is no meaningful European budget which can be drawn upon for such cases. Moreover, a fixed rule to share the costs (e.g. the key used in the Statute of the ESCB and the ECB to distribute monetary income; this key is based on an average of the share of the GDP and the total population of the participating members) may give rise to moral hazard, as countries with a weak financial system may face reduced incentives to prevent potential bail-outs. A fixed rule may thus not be politically feasible (or desirable), as countries with a strong financial system may not be prepared to pay up each time. Further research is needed to explore mechanisms for cooperation between a putative European System of Financial Supervisors and national tax authorities to deal effectively with pan-European threats to financial stability (Goodhart and Schoenmaker, 2006).

5. Conclusions

Supervisory structures should, in our view, adapt to market developments and not the other way round. The paper therefore starts with identifying the key industry trends. The first trend is centralisation of key management functions, such as risk and capital management, at the head-quarters of financial groups (banking groups, insurance groups as well as financial conglomerates). This reinforces the role of the home country supervisor as consolidating supervisor. The role of the consolidating supervisor is acknowledged in the recently adopted Capital Requirements Directive (Basle II) for banks. The current revision of the Insurance Directives (Solvency II) should, in our view, also establish adequate group supervision of large insurance firms. Although the risk profile of banks and insurers differs, supervisors have to find a way to respond to centralisation of key management functions at banking and insurance groups.

The second trend is ongoing integration of EU financial markets fostered by the advance to EMU and the nearly full completion of the Financial Services Action Plan. This integration gives rise to increasing cross-border penetration of interbank markets and payment systems, which are important channels for cross-border contagion. Furthermore, emerging pan-European banks give rise to cross-border externalities arising from the (potential) failure of these banks. The data indicate that cross-border presence is even larger for insurance firms. The increasing presence of banks (and insurers) from other EU countries undermines the capacity of host authorities to manage effectively the stability of their financial system.

Due to these market trends, it is increasingly difficult to organise financial supervision and crisis management on a predominantly national basis. In the current national setting, home supervision will remain important, and possibly expand because of group-wide internal models run from the head office of financial groups. At the same time, host supervision of subsidiaries will continue because of financial stability concerns in the host country. Duplication of supervisory efforts and multiple reporting by financial groups are therefore not likely to diminish in the near future.

This raises the question of the appropriate division of responsibilities between home and host authorities. **In our view a European System of Financial Supervisors could combine the advantages of a European framework for financial supervision and crisis management with the expertise of local supervisory bodies.** Such a System can be created by the establishment of a European Financial Authority working in tandem with the national financial supervisors. The focal point would remain at the national level, as the home supervisor would conduct the day-to-day supervision. Key supervisory (and crisis management) decisions as well as the design of policy would be done at the centre (governed by a council with executive directors of the new European Financial Authority and the chairmen of the national supervisors). In this way, host country authorities would be fully involved and the interests of their depositors fully taken into account.

How and when to get there? We believe in an evolutionary process (see also Papademos, 2005). The recently created level 3 committees can form the nexus for a new European System of Financial Supervisors. **During the next five years, we expect further discussions on the desirability and workings of a putative European System of Financial Supervisors. Then we expect another five years to implement a new System. Market developments will no doubt dictate the exact speed of the evolution.**

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Part II: Comments by ELEC Members

The perspective of a practising banker

Marianne[12] Kager

Dirk Schoenmaker and Sander Oosterloo are perfectly right in their analysis of current trends in the European financial system. As risk management techniques have become more refined and more complex, risks are increasingly managed centrally from the head-quarters of large groups of companies. Moreover, the volume of cross-border activities has grown and pan-European financial institutions are now conducting their cross-border activities slightly more via subsidiaries instead of branches (see Figure 2). Expansion is no longer pursued through greenfield investments but by acquiring market share. Of course, this has consequences for the supervised banks and for supervisory authorities.

The authors use two arguments to criticise the current supervisory regime – expensive multiple reporting by banks and the lack of attention to spill-over effects or externalities as the markets become increasingly integrated ("a failure in one country may cause problems in other countries"). I would like to add a third aspect, namely competition. This results not only from differences in supervisory practice, but to a large extent it is also a consequence of the fact that supervisory legislation for financial market regulation and supervision still differ, even between EU Member States. Beside the fact of non-harmonised parts of regulatory and supervisory rules, also the principle of minimum harmonisation and mutual recognition are in this respect limited.

The European regulatory framework

The authors are also right in respect of future policy options. I share their view that improved cooperation and coordination alone will not suffice to resolve current problems. What is required for the authors' concept of an integrated European System of Financial Supervisors?

The question is whether the system of financial supervision in Europe that is proposed can overcome the weaknesses of the current system (which they rightly criticise) without the need for a fundamental redesign of the legal framework at the European level to implement the authors' proposal. Two factors are essential in assessing this question: the competence of supervisory authorities and the harmonisation of regulatory and supervisory legislation.

- **Competence of supervisory authorities** The authors explicitly say that European supervisory authorities are "still nationally rooted with some elements of European coordination". National supervisory authorities are required to implement and monitor compliance with national laws (unless EU law must be directly applied via Regulations) and their powers are determined by the respective national rules. In my opinion, it is important to note that in Europe there is no harmonisation of the powers of supervisory authorities. In some countries, the legislator uses laws to define the general scope and largely leaves the issuance of implementing (detailed rules) to the supervisory authorities. Other EU member countries use laws to issue detailed supervisory rules. As a result, national rules defining the tasks and competence of European supervisory authorities differ from country to country.

  This is an important point in connection with the delegation of supervisory competences between host and home (consolidating) supervisor. The Commission has also referred to this problem in its most recent report[13] by pointing out that supervisory authorities have largely similar powers in respect of admission, on-site inspection and rights to information; however, sector-specific powers, such as margins of assessment provided by the CRD, differ widely.

- **Harmonised and non-harmonised supervisory legislation** The main supervisory duty is to ensure the prudential soundness of the system as well as for the individual bank. Other duties like transparency and good functioning of the market or certain aspects of depositor/investor protection may be determined either in the respective banking legislation

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[13] Report on Financial Supervision, FSC 4155/1/05

or in other national laws. (An example of the first case is the deposit guarantee scheme; an example of the second, consumer protection laws.)

The scope of EU harmonisation of the legal framework in these areas varies widely. Even prudential supervision, which is mostly harmonised, is largely based on the principle of minimum harmonisation, which permits stricter national rules. Nevertheless, even an important supervisory tool like the liquidity requirement for banks (not to be confused with minimum reserve requirements, which are standardised, at least in the EMU area) is not harmonised within the EU. Issuing such rules is the sole responsibility of the competent national authorities or legislators.

Enhancing efficiency

This raises the question of whether the European System of Financial Supervisors proposed by the authors can achieve the stated objective of reducing costs within the given legal framework.

According to the current proposal:

- "*the small and medium-sized banks are supervised by the national supervisors*
- *the pan-European banks are supervised by the consolidating or lead supervisor; he will be the single point of contact for all reporting schemes (no reporting to the host authorities), validate and authorise internal models, approve capital and liquidity allocation, approve cross-border set-ups of functions and decide on on-site inspections*"

For pan-European groups of companies, this is intended to avoid expensive duplication in complying with regulatory rules and reporting. Risk is to be assessed for supervisory purposes where the decision on it is actually made - group head-quarters in the home country.

As a rule, pan-European banks are groups of companies having separate subsidiaries in the individual Member States, and these subsidiaries are subject to host-country laws. Therefore, applying the laws and regulations of the home-country (consolidating) supervisor directly to the subsidiaries in other Member States will hardly be possible (or not at all) without a corresponding European legal basis.

Theoretically, supervisory duties could be transferred from host supervisor to home (consolidating) supervisor by way of delegation of responsibilities (whether this is politically feasible, is a different matter). The home supervisory authority, for example, would then be responsible for implementing and controlling the supervisory legislation of host supervisors in the subsidiaries situated in the respective Member States.

The question of whether such comprehensive delegation is actually possible under applicable laws would have to be examined. The Commission, in its most recent report[14], expresses its doubts, stating that it may be necessary to establish "a general legal framework in which delegation might take place." Even in such a case, the problem of different powers of national supervisors would still have to be resolved. After all, a party can only delegate responsibilities which it has.

This means that the home (consolidating) supervisor may have a set of different competences in supervising the various subsidiaries of a group. Therefore a European System of Financial Supervisors based on the delegation of responsibilities would not resolve the efficiency problem. Despite such delegation, a group of companies would have to use multiple calculations to comply with supervisory regulations because the individual subsidiaries would still be subject to national laws which cannot be repealed through delegation of supervisory competence. (This is true all the more where the allocation of capital and liquidity requirements are defined in detail by the national legislator and not by the supervisory authority. This is the case in many Member States.)

CRD and Article 129 – Moving in the right direction?

Art. 129 of the CRD authorises the lead supervisor, i.e. the consolidating supervisor, to validate and authorise the internal models and requires the national supervisors to cooperate for this purpose. Art. 129 is certainly a step in the right direction; realistically, however, it should not be

[14] Report on Financial Supervision

expected to resolve the problem of multiple calculations to comply with supervisory regulations. In this respect, the CRD, with its roughly 100 national options that are partly in core provisions of supervisory regulations, has not brought any improvement on the current status – on the contrary. But even the effect of Article 129 itself is limited. For example, the CRD provides for permanent exceptions to the use of internal models for specific sub-portfolios, but leaves the Member States free to apply this exception or not. What if the host country does not permit such exception but the home country does? **Let's take our example of BA-CA and UniCredit and assume Austrian legislators use the national discretion and the Italian not. In this case, and despite Article 129, BA-CA would have to include the sub-portfolio in the internal model, while UniCredit would have to use the standard approach for the same sub-portfolio of BA-CA in its consolidated figures.**

To sum it up: even if far-reaching delegation were possible (see also the Commission's report: "...would probably require legislative change, perhaps establishing a general legal framework in which delegation might take place."), with the given level of harmonisation, the cost burden on banks resulting from multiple calculations to comply with supervisory regulations would not significantly change.

In my opinion, the authors' proposal is good and deserves support, but it can only become effective if European supervisory regulations are further standardised. This is also to some extent stated by the authors, who write that "such a uniform policy framework would very much build on a uniform regulatory framework established by EU Directives" and "it can be questioned, whether the EU Directives are sufficient, because directives often allow national discretion". But the authors do go further “In order to make this system work, policy rules (e.g. the rulebook and reporting requirements for institutions under supervision) and information pooling (e.g. reporting format and computer systems) need to be made uniform.”

This is the very essence of the matter: without far-reaching harmonisation, the problem of duplication cannot be resolved, unless a radical political decision is taken at the European level to the effect that groups of companies are only subject to supervision at the group level by the home (consolidating) supervisor, and no longer at the stand-alone or sub-consolidation level by the host supervisor.

In the area of prudential supervision (and in this area only), such a move would not require too many changes to the EU regulatory framework itself[15]. The current national option, exempting subsidiaries which are included in the consolidated financial statements of the parent company from supervision on a stand-alone basis, could be converted into a mandatory provision binding on the Member States, and the restriction of this provision to consolidation within a Member State could be lifted by extending the application of this provision to subsidiaries in other Member States. However, I doubt that it will ever be possible to reach a political consensus on this issue. And I dare say that the higher the degree of pan-Europeanisation in the financial services sector, the less likely is the prospect of such consensus being reached. One has to bear in mind that in some of the new Member States, the market share held by subsidiaries of foreign banks is between 80 % and over 90 %. Therefore, politically speaking, it is not realistic to believe that a country will leave 80 % or more of the responsibility for its financial stability to foreign supervisory authorities.

Externalities

The risk of cross-border contagion grows with the increasing penetration of national markets by pan-European banks. There is general agreement that closer cooperation and information provided by supervisory authorities on a mutual basis is an effective measure of preventing such contagion. It is doubtful, however, whether this question can really be resolved through the transfer of the information monopoly (in reporting only to the home authorities) to the home-country supervisor. Frequently, it is local information from the market, in combination with reporting by the bank concerned, that enables supervisors at an early stage to draw conclusions as to a bank's solvency. In this respect, the national supervisor certainly has a lead over the home-country supervisor.

[15] The question of whether the EU Treaty would permit such a rule is not discussed here.

On the other hand, while the reporting system proposed by the authors can give national supervisors important information on the structure of a group's total exposure, its own scope is strictly limited by the system. In the case of difficulties experienced by a group of companies, the operational part would be the European System of Financial Supervisors (ESFS). The authors are aware of the potential conflicts of objectives between national political responsibility and host or multinational supervision: *"The policy question is whether home-country control (for supervision) and host-country responsibility (for financial stability) is sustainable in an integrated market."* And this is inseparably linked with the question of who is the lender of last resort, ultimately bearing the cost of restoring a lopsided financial system to health. As long as national taxpayers bear the cost at the end of the day, national politicians can hardly be expected to delegate national supervisory competence. In the event of a financial crisis, the question of the home supervisor or of the ESFS's competences and resources is as crucial a point as the functioning of the whole concept, which should be discussed in detail.

Conclusions

In their contribution, the authors are drawing attention to the trends in the financial services industry. The proposal they are making is certainly pointing in the right direction. However, without any further harmonisation of regulatory legislation and of the competence of (national) supervisory authorities, their proposal can only be realised in part.

As a first step, European regulatory legislation should be analysed to see:
- which of these rules need to be standardised at the European level (maximum harmonisation),
- for which of them it is possible in the consolidation of groups of companies to recognise the host-country regime for the host-country part (recognition by home-country (consolidating) supervisor),
– and which regulations only require minimum harmonisation or no further harmonisation.

Last but not least, another "risk" which is involved in the authors' proposal and should not be underestimated in the long term, is the possible emergence of two completely separate sets of supervisory regulations, namely a national one for small banks and a trans-European system for large banks. It is doubtful whether this is really the result policy-makers aim to achieve. Indeed, the authors argue that the pan-EU body must be "responsible for the correct and uniform application of supervisory rules". Nevertheless, there must be an intensive discussion on an appropriate supervisory system. The authors have made an important contribution to such a discussion.

The implications for deposit guarantee schemes

Graham Bishop[16]

The paper by Schoenmaker and Oosterloo indeed makes an important contribution to the debate on the future of European financial regulation. First, it breaks new ground in providing empirical evidence that the industry is developing so quickly that policy-makers need to catch up as a matter of some urgency. Secondly, they explain vividly why the benefits of centralised risk management will provide a powerful incentive for both banks and insurance companies to develop an economic management system that increasingly diverges from the notional legal structure. Moreover, ECB President Trichet recently warned that the increased links between different types of financial institution can increase risks to financial stability. *"The increased linkages between banks, insurance companies and pension funds may also increase potential vulnerabilities."*

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Do these apparently arcane problems really matter? The answer must be an emphatic Yes, as the financial history of a number of EU states illustrates. The UK suffered a profound shock from the "secondary banking crisis" in the early 1970s, following on from the liberalisation of the banking system. More recently, EU Member States Sweden and Finland suffered massive banking crises in the early 1990s (as did Norway), following their banking liberalisation. According to a Commission study[17], *"The Finnish economy started to decline in 1990 and real income did not return to its pre-crisis trend until 1994 with a cumulative loss of real income of 26.4 percentage points."* Sweden escaped somewhat more lightly, but it was still one of the most severe downturns in the 20th century *"Between 1990 and 1993 the loss of real income was 13.0 percentage points."* **So the mechanics of resolving a financial crisis that can spread with frightening speed do need to be thought through in advance – and be robust against ramifications that seem almost unimaginable in advance.**

The Schoenmaker/Oosterloo paper analyses three basic policy options but comes to a sobering end-point "*Finally, European supervision raises the thorny issue of who should bear the fiscal costs of a possible bail-out. The first-best solution is to keep decision-making on supervision and fiscal bail-outs at the same level. However, there is no meaningful European budget which can be drawn upon for such cases. Moreover, a fixed rule to share the costs (e.g. the key used in the Statute of the ESCB ….) may give rise to moral hazard, as countries with a weak financial system may face reduced incentives to prevent potential bail-outs. A fixed rule may thus not be politically feasible (or desirable), as countries with a strong financial system may not be prepared to pay up each time."*

Europe's citizens are keen to gain the benefits of a single financial market but are likely to be blissfully unaware that it may bring unknown risks during the transition period. So there is a strong duty on policy-makers to address these issues at an early stage. Fortunately, the Austrian and Finnish Presidencies - covering the whole of 2006 - have shown themselves to be aware and their joint programme highlights that "*attention will be paid to further improving supervision of cross-border institutions, improving stability and crisis management arrangements and in particular to the review of the Directive on deposit guarantee schemes."*

But, paradoxically, the rest of "official" Europe keeps saying there is no need for any of this. The Secretary-General of CESR recently rejected the view that the EU needs its own SEC. Moreover, the Commission's White paper on Financial Services Policy was explicit "The central policy of the Commission is to keep faith with this [Lamfalussy] process and develop it over the next 5 years to fulfil its maximum potential." But it did concede that "obligations to cooperate and exchange information between supervisors have to be reinforced. Co-operation in crisis situations has to be secure." Then it simply listed some practical supervisory challenges.

So why has the debate not died away? No one foresees a financial crisis of a magnitude that could suddenly change the entire game and even recent scandals have only led to a tightening of accounting and auditing rules. Is there a deep-seated force working towards converting the discussion into reality? Certainly there is the minimum necessary requirement of a powerful industrial lobby group – the European Financial Roundtable (EFR) – pushing for a "lead supervisor". But is that sufficient?

"The EFR has argued that a more efficient and effective supervision of financial institutions is a key element to improve growth and integration of European financial markets… the appointment of a fully empowered lead supervisor for each financial institution is considered to be a realistic way to achieve this goal."

However, the European Shadow Financial Regulatory Committee (ESFRC) has challenged the EFR's view on the grounds that it is currently not feasible mainly because deposit insurance and bail outs are the responsibility of the EU national Member States. So the deposit guarantee aspect

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[17] Number 224 March 2005: *How costly was the crisis of the 1990s? A comparative analysis of the deepest crises in Finland and Sweden over the last 130 years* by Lars Jonung (DG ECFIN) and Thomas Hagberg (Ekonomistyrningsverket, Stockholm)

emerges immediately as a crucial component of the debate and is already under examination – with a recent CEBS advice to the European Commission and a Commission report on the existing systems. Already, the authors have shown that Europe has nine "international banks" – as measured by their cross-border business – and it seems inconceivable that crisis management for any of them could be done now on a national basis. But the European level has no resources as the hotchpotch deposit guarantee funds are locally controlled. **This analysis underlines the interdependence of centralised supervision and deposit guarantee schemes.**

The insurance industry may find that CEIOPS has already pushed it down the road of a "lead" regulator – at least for companies operating cross-border. Moreover, the insurance industry seems to be learning the lesson from its banking colleagues and moving swiftly to put this fully on its agenda for Solvency II. The documents submitted ahead of CEIOPS recent public hearing included powerful calls for a lead supervisor concept from both the CEA and ABI, as well as the Chief Risk Officers Forum (representing Europe's largest insurers) and the mutual/co-operative insurers. Could the corollary be insurance guarantee schemes? The Comité Européen des Assurances (CEA) has started arguing against this idea almost before it has surfaced.

CEBS provided its technical advice to the Commission in September 2005. Its report concluded that *"this volatile environment makes it demanding to provide definitive answers ….While a case can be made for change, reform might impose disproportionate costs… CEBS concludes that the present regime does not currently appear to need significant amendment. However, these conclusions might change – perhaps relatively rapidly – as a result of developments…."*

The key insight from the Schoenmaker/Oosterloo paper is the quantification of the actual developments, as well as demonstrating why commercial reality will rapidly shift even further away from legal form. Moreover, the Commission's work programme for the next few years – endorsed by ECOFIN – is to create policies designed to accelerate these trends. **So CEBS should be poised for a rapid re-consideration of its conclusions.**

The key problems stem from differences in deposit guarantee schemes – depending on whether they are host country schemes that cover the parent and its branches, OR the host country system that covers subsidiaries. I**n other words, the magnitude of the political problem of the potential cost depends on the legal nature of the group's structure – just at the moment when the practical reality of its operational structure is diverging sharply from the legal facade.**

The attitudes of both bank's management and the political authorities are likely to be influenced by cost. For the bank, a funded scheme means a continuing drain on profits by way of an "insurance" premium. But how should this be calculated? CEBS supports the view that the calculation should be risk-based and the new world of CRD may offer a ready means of apportioning the premium. But what might the sum assured be? So the banker's preference may well be for an unfunded scheme where there is a commitment to contribute only if there is an actual failure. However, this begs the question of what to do with the existing assets of funded schemes.

Then there is the question of the value that is covered – ranging from €103,000 in Italy down to only €12,500 in Luxembourg. All these differences are summarised in Figure 8 – provided by the ECB, but based on 1998 data.

The mechanics of operation of such funds are discussed in the CEBS report as they have been an integral part of a Member State's consumer protection system. However, it barely mentions the topic of competition policy because that will be a new element in any decision to intervene in a major bank failure. At the extreme, a state might choose to use a state-run fund to provide support to a bank where shareholders would let it fail. That could easily be said to be an illegal state aid where the Commission would have to give agreement. However, a "run" on the un-insured interbank deposits would probably develop at such a speed that the bureaucratic procedures would be overwhelmed.

So some very fundamental issues about the nature of a state's relationship with both its citizen depositors and taxpayers need to be resolved before regulatory powers can be delegated to some form of lead regulator. However, the challenge appears to be that 30% of the EU's deposit base has already moved outside the comfortable legal silos of the past. And the pace is accelerating.

Figure 8. Deposit Insurance System Features in EU Countries, end-1998

Country	Date established	Coverage limit (per bank per depositor)	Foreign currency deposits covered	Interbank deposits covered	Administration(1	Funding
Austria	1979	20,000 euro	No	No	private	unfunded
Belgium	1974	15,000 euro (20,000 in 2000)	No	No	joint	funded
Denmark	1988	40,000 euro	Yes	No	joint	funded
Finland	1999	25,000 euro	Yes	No	private	funded
France	1980	60,000 euro	No	No	private	unfunded
Greece	1995	20,000 euro	No	No	joint	funded
Germany	1966	20,000 euro(2	Yes	No	private (private) joint(4(official)	funded
Ireland	1989	15,000 euro (20,000 in 2000)	No	No	government	funded
Italy	1987	103,291 euro	Yes	No	private (CB approves decisions)	unfunded
Lux.	1989	12,500 euro (20,000 in 2000)			private	
Netherlands	1979	20,000 euro	Yes	No	government	unfunded
Portugal	1995	25,000 euro	Yes	No	government	funded
Spain	1977	20,000 (from 2000)	Na	No	joint	funded
Sweden	1996	28,000 euro	Yes	No	government	funded
United Kingdom	1982	22,200 euro	No	No	private	mixed(3

1) The government includes the central bank.
2) The public scheme provides coverage up to 20,000 euro, but the private scheme provides coverage up to 0.3% of the liable capital of the bank for each depositor.
3) There is an initial contribution and ex post funding when needed.
4) "Joint": both governmental and private.

Source: ECB WORKING PAPER SERIES NO. 302 / FEBRUARY 2004 "DEPOSIT INSURANCE, MORAL HAZARD AND MARKET MONITORING" by Reint Gropp and Jukka Vesala

Appendix I: Extract from EP Report on Prudential Supervision

The table below is extracted from the November 2002 Report[18] by Ieke van den Burg to illustrate the range of possible outcomes to the debate on prudential supervision.

Figure 9. The Future of Supervision, (the van den Burg Report)

The future of supervision : from fragmentation to unification			
Cross-Sector (national models) / **Cross-border (European models)**	*1. Sectoral* (separation between banking, insurance/pension funds and securities)	*2. Cross-sector: functional* (separation between prudential supervision and conduct-of-business)	*3. Cross-sector : integrated* (all sectors, all practices)
A. Fragmented with cooperation	Cooperation in sectoral committees	Cooperation in functional committees	Cooperation national single agencies
B. Coordination (or enhanced cooperation)	Coordination between national sectoral supervisors (harmonisation in sectoral regulation and convergence in supervisory practices in banking, insurance/pension funds and securities respectively)	Coordination between national functional supervisors (functional EU-wide legislation and convergence in supervisory practices in prudential supervision and conduct of business supervision)	Coordination between national single agencies (tendency toward single financial services market act within the EU, convergence in supervisory practices between national single agencies)
C. Two-Tier	Separate European banking and insurance/pension funds supervisors for large institutions & national supervisors for local entities Coordination between the two level of supervision + European Financial Market Agency	European prudential supervisor for large internationally operating institutions (NB financial conglomerates) & national prudential supervisors for local entities Coordination between the two level of supervision + European Financial Market Agency	European single agency for large institutions and financial markets & national single agencies for local entities Coordination between the two level of supervision
D. Unified	Separate European banking, securities and insurance supervisors	European prudential supervisor + European Financial Market Agency	European Single Agency

[18] http://www.europarl.eu.int/omk/sipade3?PUBREF=-//EP//NONSGML+REPORT+A5-2002-0370+0+DOC+WORD+V0//EN&L=EN&LEVEL=2&NAV=S&LSTDOC=Y