Financial Supervision in the EU

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Abstract
The new European financial supervisory framework started at the beginning of 2011. Three new European Supervisory Authorities (the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority) are created to strengthen financial supervision at the EU level. These new European Supervisory Authorities (ESAs) have to work in tandem with the national financial supervisors, who remain responsible for day-to-day financial supervision.

While the new European framework is still based on the sectoral model, several EU Member States are adopting the twin peaks model (with two separate supervisors for micro-prudential supervision and conduct of business) or the integrated model (with one single supervisor) in response to the cross-sector developments of financial markets and institutions. To foster financial stability, the new ESAs participate in the newly established European Systemic Risk Board at the ECB. This new body is responsible for macro-prudential supervision at the EU level.

Key words: banking, central banks, conduct of business, European Banking Authority, European Insurance and Occupational Pensions Authority, European Securities and Markets Authority, European Systemic Risk Board, European Union, financial stability, financial supervision, insurance, investor protection, micro-prudential, macro-prudential, prudential supervision, single supervisor model, twin peaks model.

JEL Classifications: E58, F36, F42, G01, G21, G28

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1. Introduction

Financial supervision is still pre-dominantly nationally based in the European Union (EU). Each country has its own financial supervisory authorities. The ongoing process of financial integration, witnessed by cross-border banks, insurers and markets in the EU, has initiated an evolutionary approach to financial supervision at the EU level. Financial regulation is already largely covered by European legislation (EU Directives which are implemented into national legislation leaving scope for country differences, and EU Regulations which are directly applicable establishing full harmonization).

In this introduction, we briefly review the reasons for regulation and supervision of financial services. Regulation refers to the process of rule-making and the legislation underlying the supervisory framework, while supervision refers to monitoring the behavior of individual firms and enforcing legislation. The case for government intervention is based on market failures. A market failure occurs when the private sector left to itself (i.e., without government intervention) would produce a sub-optimal outcome. Goodhart et al. (1998) identify three main reasons for government intervention in the financial sector:

1. asymmetric information: customers are less informed than financial institutions. Financial supervision aims to protect customers against this information asymmetry.
2. externalities: the failure of a financial institution may affect the stability of the financial system. Systemic supervision aims to foster financial stability and to contain the effects of systemic failure.
3. market power: financial institutions or financial infrastructures, such as payment systems, may exert undue market power. Competition policy aims to protect consumers against monopolistic exploitation.

Asymmetric information arises in two cases. First, customers are generally unable to properly assess the safety and soundness of a financial institution as that requires extensive effort and technical knowledge. Establishing some sort of oversight may be needed, as financial institutions have an incentive to take too much risk. This is because high-risk investments generally bring in more revenues that accrue to the institution, while in case of failure a substantial part of the losses will be borne by the depositors. The information asymmetry creates problems of adverse selection (a riskier financial institution may make a more attractive offer to potential customers) as well as moral hazard (a financial institution may increase its risk after it has collected funds from customers). Prudential supervision aims to protect customers by ensuring the soundness of financial institutions. Moreover, governments provide direct protection to depositors through deposit insurance with a cover of EUR 100,000. However, a government safety net may provide banks with an even stronger incentive for risky behavior. Prudential supervision is thus also needed to counter this incentive by ensuring the banks’ soundness (Mishkin, 2000). Section 2 discusses prudential supervision in more detail.
Second, customers may not be in a position to assess properly the behavior of a financial institution. This problem is common in professional services (Goodhart et al., 1998). In most cases, private sector mechanisms are used to mitigate this principal-agent problem. A disciplinary body of a privately run medical association can, for example, expel a member when it finds that this member has (repeatedly) failed to meet the minimum standards of the medical profession. Why then is government supervision of financial services needed? An important explanation draws on the fiduciary nature of financial services. A customer hands over his money today, while the service is rendered in the (sometimes far) future. For example, only after retirement it becomes clear whether the advised pension savings scheme is appropriate to meet the financial needs of the retirees. Moreover, the amount of money at risk is typically larger in financial services than in other professional services. Conduct of business supervision focuses on how financial institutions conduct business with their customers and how they behave in markets. The focus is on the functions, regardless of the financial institution performing this function. Section 3 discusses conduct of business rules to mitigate the behavior of financial institutions.

The second market failure that may give rise to government regulation are externalities. There is a risk that a sound financial institution may fail when another financial institution goes bankrupt (contagion). This externality is not incorporated in the decision-making of the financial institution. The social costs of the failure of a financial institution thus exceed the private costs. In particular, banks are subject to contagion as their balance sheet contains illiquid assets financed by redeemable deposits. When rumors about the quality of a bank’s assets spread, depositors may withdraw their deposits. The liquidity and subsequently the solvency of a bank will be threatened when it has to liquidate its assets at fire-sale prices (i.e., prices well below prices under normal market conditions). The failure of multiple banks may lead to a banking crisis. Systemic supervision aims to foster financial stability and to contain the effects of systemic failure. The task of maintaining financial stability is usually assigned to a country’s central bank. The Chapter on The Role of Central Banks in Financial Stability (Schoenmaker, 2011b) explains in more detail why the financial system (and especially the banking sector) is more susceptible to systemic risk than other economic sectors and discusses the role of the central bank to contain systemic risk.

The third market failure is related to market power. In a monopoly (only one firm) or an oligopoly (a few firms which may collude), firms can raise and maintain the price above the level that would prevail under (perfect) competition. The exercise of market power by firms is at the detriment of consumers who face higher prices and less choice of products or services. Lack of competition occurs in many economic sectors. In the financial sector, economies of scale (incentive for mergers) and network economies (e.g., in payment systems or stock exchanges) may reduce competition. Competition policy aims to ensure effective competition by taking a very strong line against price-fixing, market-sharing cartels, abuse of dominant market positions, and anticompetitive mergers.

The remainder of this chapter is organized as follows. We first discuss the main forms of financial supervision (prudential supervision and conduct of business) and the organizational structure of financial supervision in the various EU countries. We then move to the new European Financial Supervisory Framework.
2. **Prudential supervision**

The current regulatory system in the EU is based on the principle of home country control combined with minimum standards and mutual recognition. A financial institution is thus authorized and supervised in its home country and can expand throughout the EU by offering cross-border services in other EU Member States or establishing branches in these countries without additional supervision by host country authorities (home country control). The host country has to recognize supervision from the home country authorities (mutual recognition), as minimum requirements for prudential supervision have been laid down in the respective EU Directives (minimum standards). However, financial institutions also operate through subsidiaries (separate legal entities) in other countries for reasons of taxation and limited liability (Dermine, 2006). These subsidiaries are separately licensed and supervised by the host country authorities.

According to Lastra (2006), *prudential supervision* can be understood as a process with four stages:

1. **Licensing, authorisation, or chartering of financial institutions** (i.e., the entry into the business). This objective of this stage is to establish whether a person is fit and proper, i.e., before a person may obtain a license, supervisors determine a person’s integrity, honesty, reputation, and capability to manage a financial services provider. In this respect, the Basel core principles for effective banking supervision state that “the licensing process at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board Members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base”.

2. **The on-going monitoring of the health of financial institutions and the financial system**, in particular the asset quality, capital adequacy, liquidity, management, internal controls, and earnings. Supervision is exercised through a broad range of instruments including off-site and on-site examinations (or inspections), auditing (internal unpublished audit and external published audits), analysis of statistical requirements, and internal controls. In case of distress in financial institutions, the supervisory authorities have to act.

3. **Sanctioning or imposition of penalties in case of non-compliance with the law, fraud, bad management, or other types of wrongdoing**.

4. **Crisis management**, which comprises lender of last resort, deposit insurance, and insolvency proceedings.

In order to cover credit, market and operational risks, banks are required to hold a minimum level of own financial resources, i.e., *capital*. These capital requirements serve as a buffer against unexpected losses, thereby protecting depositors and the overall stability of the financial system. The challenge is to determine how much capital banks need to hold in order to ensure that they are sufficiently capitalized.\(^2\) If capital levels are

\(^2\) While prudential supervision aims to minimize the risk of failure, it cannot eliminate the risk of a failing bank in a market-economy.
too low, banks may be unable to absorb potential losses but high capital levels are costly for banks.

Although it is up to banks to decide how much capital to hold, minimum requirements have been laid down by the regulatory authorities. The EU rules for supervising the capital levels are based on the so-called Basel II and Basel III framework established by the Basel Committee of Banking Supervisors. The objectives of Basel II include creating a better link between minimum regulatory capital and risk, enhancing market discipline, and supporting a level playing field in an increasingly integrated global financial system. The Basel II framework has a three-pillar structure, namely minimum capital requirements (Pillar 1), the process of supervisory review (Pillar 2), and market discipline (Pillar 3). While capital requirements used to be specified in detail by the regulatory authorities in the previous Basel Accord of 1988 (generally referred to as Basel I), the Basel II framework allows banks to use their internal risk management models for the calculation of the required amount of capital. Basel II acknowledges that is it difficult for regulatory and supervisory authorities to identify and monitor all risks to which banks are exposed. It therefore intends to provide banks with an incentive to develop and maintain state-of-the-art models for their risk and capital management. Table 1 provides a stylized overview of the Basel II framework.

### Table 1. Structure of Basel II

<table>
<thead>
<tr>
<th>Pillar 1</th>
<th>Pillar 2</th>
<th>Pillar 3</th>
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</thead>
<tbody>
<tr>
<td><strong>Credit risk</strong></td>
<td><strong>Economic capital</strong></td>
<td><strong>Transparency</strong></td>
</tr>
<tr>
<td>• Standardized approach;</td>
<td>• Assessment of risk system by the supervisory authority</td>
<td>• Disclosure requirements as to amount and composition of capital relative to risk profile.</td>
</tr>
<tr>
<td>• Internal rating based approach (foundation), and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Internal rating based approach (advanced)</td>
<td></td>
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<tr>
<td><strong>Operational risk</strong></td>
<td></td>
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<tr>
<td>• Basic indicator approach;</td>
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<tr>
<td>• Standardized approach, and</td>
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<tr>
<td>• Advance measurement approach.</td>
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<tr>
<td><strong>Market risk</strong></td>
<td></td>
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<tr>
<td>• Value at Risk approach</td>
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</table>

The first pillar covers the minimum capital requirements for credit risk, operational risk, and market risk. There are three methods for calculating the solvency requirements for credit risks depending on the sophistication of the internal risk management systems of the respective bank:

- The standardized approach is the least complex method, which makes use of fixed risk weights, i.e., different categories of assets are assigned fixed risk weights. This approach is somewhat similar to the minimum capital requirements set out in
Basel I. However, external credit ratings may be used so that capital requirements should more closely match the actual risk profile.

- Under the internal rating based approach, banks may use their own internal rating methods to calculate credit risk. In the foundation version, a bank independently calculates the probability of default, while other factors are prescribed by the supervisor. In the advanced version, all factors which are used to determine credit risk are calculated by the bank itself.

One of the new features introduced by the Basel II framework are capital requirements for operational risk. Here too, different approaches are allowed for calculating the risk. The basic indicator approach makes use of a single indicator for quantifying operational risk for the overall operations of the bank. The standardized approach, on the other hand, makes a distinction between the different business lines of the bank. Finally, the advance measurement approach enables a bank to use internal and external data on operational losses to calculate the required level of capital. The preferred approach to measure market risk is the Value at Risk (VaR) method.

Pillar 2 of the Basel II framework is the so-called supervisory review. Pillar 2 requires each bank to develop its own internal process for assessing capital adequacy. To check the accuracy of the capital assessment, banks have to perform regular back-tests of realized outcomes against model-estimates and stress-tests of certain scenarios (e.g., a 10 percent downturn of the stock market and/or a 2 percent increase in interest rates). The supervisory review entails that supervisory authorities examine the activities and risk profile of the bank in order to see whether there is a need for banks to hold additional capital (on top of the level of capital calculated under Pillar 1). Moreover, the supervisory review enables the supervisor to take account of risks which are not covered in Pillar 1, e.g., concentration risk, interest rate risk, legal risk, and liquidity risk.

The objective of Pillar 3 is to enhance market discipline by increasing the transparency of the amount and composition of a bank’s capital relative to that bank’s risk profile. Pillar 3 recognizes that market discipline has the potential to reinforce minimum capital standards (Pillar 1) and the supervisory review process (Pillar 2), and thereby promoting the safety and soundness of banks. It is argued that market discipline imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner, including an incentive to maintain a strong capital base.

In the EU, the Basel II framework has been implemented as of 2008 by means of the Capital Requirements Directive (CRD, 2006/48/EC and 2006/49/EC). However, while the Basel II framework has been developed for large internationally active banks, the CRD is being applied to all banks as well as investment firms. Among other things, the CRD enhances the role of the ‘consolidating supervisor’, i.e., the supervisor in the Member State where the group’s parent institution is authorized. This supervisor is responsible for group level supervision of capital adequacy, concentration risk, and systems and controls. Moreover, the consolidating supervisor has specific responsibilities and powers in coordinating supervision of a cross-border banking group.

The European Commission has adopted a somewhat similar system for the regulatory capital of insurance companies, the Solvency II Directive (Solvency II, 2009/138/EC).
This directive, also nicknamed Solvency II, introduces more sophisticated solvency requirements for insurers, in order to guarantee that they have sufficient capital to withstand adverse events, such as floods, storms, or big car accidents. This will help to increase their financial soundness. Currently, EU solvency requirements only cover insurance risks, whereas in the future insurers would be required to hold capital also against market risk, credit risk, and operational risk. The Solvency II directive draws on the experiences from banking and follows the three pillar approach of the Capital Requirements Directive.

Critics of the Basel II framework argue that the Basel II framework has failed to address many of the shortcomings in the regulatory system and even creates potential new sources of risk. First, critics question whether the heavy reliance on credit rating agencies is sensible, as these are unregulated entities and it is difficult to assess the quality of their assessments. Conflict of interest may arise as there is a close (financial) relationship between rating agencies and the entities under examination.

Second, the pro-cyclical effects of Basle II have been criticized. Financial regulation is inherently pro-cyclical, because capital requirements imply that financial institutions have to hold more capital when credit risk increases, which is generally the case in an economic downturn. If financial institutions have to increase capital, they can lend less to firms and households, thereby stimulating the downturn. The reverse reasoning applies in case of economic upswing (see Box 1 for a further discussion on pro-cyclicality in bank lending). Danielsson et al. (2001) argue that the Basel II framework will exacerbate this tendency significantly. They argue that risk assessments, whether based on credit rating agencies’ assessment or internal ratings, do not assess risk ‘through the cycle’.

The Basel III Framework, adopted in December 2010, strengthens the regulatory capital framework, building on the three pillars of the Basel II framework (BIS, 2010a). The reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the capital framework. They are underpinned by a leverage ratio (equity to total assets) that serves as a backstop to the risk-based capital measures, is intended to constrain excess leverage in the banking system and provides an extra layer of protection against model risk and measurement error. Finally, Basel III introduces a number of macro-prudential elements into the capital framework to help contain systemic risks arising from pro-cyclicality and from the interconnectedness of financial institutions (see Box 1).

Basel III also introduces two minimum standards for funding liquidity (BIS, 2010b). The first standard promotes short-term resilience of a bank’s liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month. The Liquidity Coverage Ratio (LCR) specifies that a bank should have sufficient highly liquid assets to survive a 30 day stress scenario. The second standard promotes resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. The Net Stable Funding Ratio (NSFR) has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities.
In the EU, the new Basel III rules will be implemented by adapting the relevant EU Directives.

<table>
<thead>
<tr>
<th>Box 1 Pro-cyclicality in bank lending?</th>
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<tbody>
<tr>
<td>The business cycle determines the prospects for business. The default rate of companies is low during an economic boom, while the default rate is high during a recession. The business cycle is thus an important driver of credit risk.</td>
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</table>

The probability of default and the related recovery rate (i.e., the part of the loan that is recovered in case of default) are not constant in time. In expanding economies, default probabilities decline and recovery rates improve. This results in declining rates on loans due to declining risk premiums. As loan rates go down, further loans are granted fuelling the economic expansion. This is an example of pro-cyclicality. The reverse process can also happen. Increasing loan rates (due to rising default probabilities) in a recession cause a decline in new loans.

There is also a second effect. Losses in the loan book lower a bank’s profitability. A bank’s capital is then reduced as profits are added to capital and, worse, losses are deducted from capital. At the same time, capital requirements for loans increase as the credit risk on loans goes up. If banks are capital-constrained, they cannot grant new loans. This process could end in a full blown ‘credit crunch’, where banks are no longer able to provide business with new credit.

The Basle Committee has recognized the problem of pro-cyclicality. The solution is to take the default probability (and related recovery rate) as an average of the default probability through the economic cycle, rather than an estimate at one point in time. However, when default probabilities are estimated in this manner the systemic component of default risk might be ignored. So except for an ‘average year’, regulatory capital will not reflect the actual risk and may overstate the true risk in economic booms and understate risk in an economic downturn. In addition, the new Basel III rules incorporates a countercyclical capital charge moving from 0% (in bad times) up to 2.5% (in good times).

The cyclical bias has also a psychological component. Guttentag and Herring (1984) have introduced the concept of ‘disaster myopia’, which means that the subjective probability of a major shock is a negative function of the time since the last shock happened. A good example is air travel. Passengers’ feeling of safety decreases after one or more reported airplane crashes, while the safety feeling increases after a prolonged period with no major crashes. Similarly, it is possible that subjective probabilities of default decline during an economic boom (no major defaults), while actual probabilities remain constant.
3. Conduct of business

Conduct of business supervision focuses on how financial institutions conduct business with their customers and how they behave in markets, by prescribing rules about appropriate behavior and monitoring behavior that can be harmful to customers and to the functioning of markets. It is a relatively new activity, which became prominent after the liberalization of financial markets. In the so-called Big Bang in 1986, fixed commissions for trading at the London Stock Exchange were abolished. The Big Bang was the start of a process of liberalizing financial markets across Europe. Liberalization promotes entry of new players and may thereby lead to a wider choice of products and services (at lower prices). Conduct of business rules ensure a fair treatment of, in particular, retail customers in these liberalized markets.

The focus of conduct of business regulation is on the activities of financial institutions. The dividing lines between the sub-sectors of banking, insurance, and securities are blurring; the same type of product is increasingly offered by different financial institutions. Merton (1995) proposes a functional approach towards regulation to prevent regulatory arbitrage between different types of financial institutions. So, the same conduct of business rules should in his view apply to whoever (a bank, an insurer, or an investment firm) is offering, for example, long-term savings products to retail customers.

Protecting retail customers
Conduct of business rules protecting retail customers comprise the following elements (Llewellyn, 1999)³:
- mandatory information provision;
- objective and high-quality advice;
- duty of care.

Mandatory information provisions ensure that customers get the right information at the right time. Selecting an inappropriate product can have adverse consequences for retail customers and an important safeguard against this is proper disclosure and sufficient information (transparency). Good information helps customers to understand the key features of a financial product, including the risks, potential returns, and costs. Mandatory information provisions specify the (minimum) information needed to understand products. These provisions also require financial institutions to present this information in a consistent format to compare products.

Developing customers’ literacy in financial matters is becoming increasingly important, as individuals take many decisions affecting their financial security and capital markets have become more accessible to consumers. The European Commission (2007) reports that international surveys demonstrate a low level of understanding of financial matters on the part of customers. There is a strong correlation between low levels of financial literacy and the ability to make appropriate financial decisions. Customers with poor

³ The integrity and competence of financial institutions is not listed here as a specific conduct of business element. Fit and proper rules are general requirements that are applied in both prudential and conduct of business regulation (see section 2).
financial literacy find it hard to understand and make use of the information they receive when purchasing financial services.

Conduct of business rules can also give guidelines for the quality and objectivity of advice. Providing advice is distinct from providing information. Whilst information merely describes the (essential) characteristics of a product or service, advice implies a recommendation to a given customer to opt for a specific product. A financial institution must take steps to ensure that a recommendation is suitable for its customer. This can, for example, be done by making a customer’s profile containing information about the customer’s knowledge and experience relevant to the specific type of financial product, financial situation, and investment objectives. When advice is given, it should be objective, based on the profile of the customer, and commensurate with the complexity of the products and the risks involved. The requirement of objectivity aims to minimize potential conflicts of interests when financial institutions are better informed than customers. Customers in some countries rely on independent advice to make appropriate decisions.

More generally, financial institutions have a duty of care towards their customers. A duty of care is an obligation imposed on financial institutions requiring that they adhere to a reasonable standard of care while dealing with customers. It aims to enhance responsible behavior of financial institutions. A financial institution breaches its duty of care when it sells, for example, a high risk investment product to a customer who cannot afford to bear the financial risk (e.g., a low income household with limited savings).

Summing up, on the one hand, conduct of business rules require proper information provision (transparency) to (potential) customers. This should enable customers to take better decisions. On the other hand, conduct of business rules set minimum standards for advice and introduce a duty of care for financial institutions. The challenge for policymakers is to find the right balance between empowering customers by providing information and education (fostering financial literacy) and protecting customers by setting minimum standards for financial institutions’ behavior.

In the insurance markets, intermediaries play a vital role in selling insurance products. They also play a role in protecting the interests of insurance customers, primarily by offering them advice and assistance and by analyzing their specific needs. At the same time, insurance intermediaries face incentives to sell products on which they earn a high commission, while these products are not always suitable for the customer. The Insurance Mediation Directive (2002/92/EC) contains rules to ensure a high level of professionalism and competence among insurance intermediaries whilst guaranteeing a high level of protection of customers’ interests.

EU rules are most advanced in the field of securities. The Markets in Financial Instruments Directive (MiFid; 2004/39/EC), which replaced the Investment Services Directive (93/22/EEC), comprises a comprehensive set of operating conditions applicable to both banks and investment firms that regulates the relationship between these firms and their clients. This framework consists of a set of conduct of business, best execution, and client order handling rules, as well as inducements and conflicts of interest.
provisions. Specific attention is paid to retail clients for whom a specific regime has been established, which entails reinforced fiduciary duties upon the firm.

Another set of EU rules in investment services field are contained in the Undertakings for Collective Investments in Transferable Securities Directive (UCITS; 2001/107/EC and 2001/108/EC; subsequently updated 2009/65/EC) . UCITS are a set of EU directives that allow collective investment schemes to operate freely throughout the EU on the basis of a single authorization. A collective investment fund may apply for UCITS status in order to allow EU-wide marketing.

**Market functioning**
Conduct of business regulation promoting fair and orderly markets contain the following elements:

- transparency of trading;
- prohibition of insider trading and market manipulation;
- information requirements for issuers, including prospectus and financial reporting, and for shareholders.

Rules on the **transparency of trading** require disclosure of quotes, i.e., prices at which traders are prepared to sell or buy securities, and of prices at which trades have taken place. Potential investors can only analyze and compare trading conditions for securities, when quotes (pre-trade transparency) are published. Post-trade transparency is also important to get timely insight in the movement of prices. The transparency requirements seek to achieve an adequate price formation process, to ensure best execution and to provide for a level playing field between the different types of trade venue.

Insider trading and market manipulation undermine the proper functioning and integrity of markets. **Insider trading rules** put a ban on trading with inside information, i.e., material information on the firm that is not yet made public. The use of this information by insiders, such as management or employees, may influence the price of the firm’s securities. To speed up the release of new information (and thus reduce the potential for insider trading), insider trading rules require listed firms to disclose inside information as soon as possible. It thus promotes transparency and equal treatment of investors. **Market manipulation rules** prohibit the spread of rumors to influence (i.e., ‘manipulate’) the price of a security.

Firms that issue securities are required to publish information on a regular basis. First, firms have to publish a prospectus when they are issuing securities. A **prospectus** commonly provides investors with material information about the firm’s business, financial statements, biographies of officers and directors, detailed information about their compensation, any litigation that is taking place, a list of material properties, and any other material information. Next, listed firms have to provide annual financial reports. In addition, half-yearly or quarterly financial reports may be required. The purpose of financial reporting is to ensure comparable, transparent, and reliable information about firms. Finally, shareholders have to disclose acquisitions (and disposals) of shareholdings beyond the 5 percent threshold. In that way, firms can identify their major shareholders.
The conduct of business rules for markets are laid down in a raft of EU Directives. The Markets in Financial Instruments Directive (MiFid; 2004/39/EC) contains *inter alia* rules on transparency of trading. MiFid expands trading from regulated markets (i.e., stock exchanges) to multi-trading facilities (MTFs), i.e., systems that bring together multiple parties (e.g., retail investors or other investment firms) that are interested in buying and selling financial instruments and enable them to do so. MiFid also facilitates in-house matching. Under certain conditions regarding pre-trade transparency and best execution, banks and investment firms are allowed to ‘match’ trades of customers internally. MiFid came into force on 1 November 2007 and had a big impact on the structure of equity markets.

The Market Abuse Directive (2003/6/EC) harmonizes the rules for insider trading and for market abuse. It requires closer co-operation and a higher degree of exchange of information between national authorities, thus ensuring the same framework for enforcement throughout the EU and reducing potential inconsistencies, confusion, and loopholes. The Prospectus Directive (2003/71/EC) requires that prospectuses provide investors with clear and comprehensive information. This directive makes it easier and cheaper for companies to raise capital throughout the EU on the basis of a single prospectus approved by a regulatory authority (‘home supervisor’) in one Member State.

Finally, the Transparency Directive (2004/109/EC) requires that all securities issuers must provide annual financial reports within four months after the end of the financial year. As for the contents of the financial reports, the EU has adopted the International Accounting Standards (IAS) – now referred to as International Financial Reporting Standards (IFRS) – through the IAS Regulation (1606/2002/EC). The IAS provides a single set of comparable global accounting standards issued by the International Accounting Standards Board (IASB).
4. Supervisory structures

The organizational structure of financial supervision is in the process of change in most EU Member States. All countries used to have a sectoral model of financial supervision with separate supervisors for banking, insurance, and securities reflecting the traditional dividing lines between financial sectors. However, financial conglomerates represent about 25 percent of the banking market and the insurance market. Furthermore, financial products are converging. Banking as well as life insurance products, for example, serve the market for long term savings. Because of the blurring of the dividing lines between financial sectors, cross-sector models of supervision have emerged. There are two main cross-sector models of supervision: a functional (or ‘twin peaks’) model and an integrated model.

In the functional model, there are separate supervisors for each of the supervisory objectives: prudential supervision and conduct of business (see column (2) in Table 2). Referring to these two objectives, the functional model is also known as the ‘twin peaks’ model (Taylor, 1995). In some countries, especially in the euro area where central banks have transferred their responsibility for monetary policy to the ECB, the central bank is responsible for prudential supervision. In other countries (e.g., Australia), a separate agency is responsible for prudential supervision.

In the integrated model, there is a single supervisor for banking, insurance and securities combined (or, put differently, one supervisor for prudential supervision and conduct of business combined). There are two modes of the integrated model. Scandinavia has adopted a fully integrated model without central bank involvement in financial supervision (see column (3a) in Table 2). In Germany and Austria, the central bank still has a role in banking supervision. The findings of the central bank are provided to the integrated supervisor, who has final authority (see column (3b) in Table 2). Box 2 provides an overview of country experiences with the various models.

Table 2. Organizational structure of financial supervision

<table>
<thead>
<tr>
<th>Countries</th>
<th>Basic models</th>
<th>(2) Cross-sector: Functional</th>
<th>(3a) Cross-sector: Integrated without central bank role in banking supervision</th>
<th>(3b) Cross-sector: Integrated with central bank role in banking supervision</th>
</tr>
</thead>
</table>

Note: In parentheses the year of establishment of the new cross-sector supervisor(s) is shown.
The functional model combines the objectives of systemic supervision and prudential supervision, leaving conduct of business supervision as a separate function. The integrated model combines the objectives of prudential supervision and conduct of business supervision, leaving systemic supervision (financial stability) as a separate function that is usually performed by the central bank.

Kremers *et al.* (2003) have developed a framework to analyze the trade-offs by listing the synergies and conflicts of supervisory interests of both models. Figure 1 summarizes these potential synergies and conflicts. The first synergy in the left panel of Figure 1 results from combining systemic supervision and prudential supervision of financial institutions. The synergy between stability issues on a micro level (at the level of the financial institution) and a macro-level (economy-wide) refers to the possibility to act decisively and swiftly in the event of a crisis situation. Crisis management usually requires key decisions to be taken within hours rather than days. Combining both micro- and macro-prudential supervision within a single institution ensures that relevant information is available at short notice and that a speedy decision to act can be taken if necessary.4

The second synergy in Figure 1 is ‘one-stop supervision’, i.e., the synergy between prudential supervision and conduct-of-business. This relates to the fact that it confronts all types of financial institutions with one supervisor only for prudential and conduct-of-business supervision. Furthermore, synergies in the execution of supervision are exploited by combining different supervisory activities within one institution.

**Figure 1. Supervisory synergies and conflicts**

<table>
<thead>
<tr>
<th>Supervisory synergies</th>
<th>Objectives</th>
<th>Conflicts of supervisory interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Link macro- and microfinancial stability; no crisis management by committee</td>
<td>Financial stability: Macroprudential</td>
<td>Pressure to extend scope of safety net versus to limit moral hazard</td>
</tr>
<tr>
<td>One-stop supervision</td>
<td>Financial stability: Microprudential</td>
<td>Focus on profitability and stability of institution versus interests of clients</td>
</tr>
<tr>
<td>Conduct-of-business</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Kremers *et al.* (2003)*

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4 The Northern Rock crisis in 2007 indicates that crisis management by two institutions may not be very effective. According to Buiter (2007), the coordination between the Bank of England and the FSA has been wanting.
The first potential conflict of interest between systemic supervision and prudential supervision relates to the possibility of lender of last resort operations (LOLR) by the central bank. How to balance the pressure to extend the benefits of LOLR operations (avoiding systemic risk, like a financial panic or bank runs) to all financial institutions against its costs (moral hazard)? The answer adopted by many central banks is to limit the possibility of LOLR-operations to banks, which are subject to systemic risk (see the Chapter on The Role of Central Banks in Financial Stability, Schoenmaker 2011b). LOLR-operations are then not available to insurance companies. However, when financial groups integrate, it may become more difficult to separate the banking part of financial institutions that justify the possibility of LOLR-operations.

The second potential conflict of interest between prudential supervision and conduct-of-business supervision relates to the different nature of their objectives. The prudential supervisor will be interested in the soundness of financial institutions including profitability, while the conduct-of-business supervisor will focus on the interests of clients. Mixing up both responsibilities of financial stability and conduct-of-business could lead to incentives for the supervisor to give prevalence to one objective over the other. By separating the supervisory functions, the conduct-of-business supervisor is ideally situated to supervise possible conflicts of interest between a financial institution and its clients, since it will only focus on the interests of the clients. Furthermore, the stability objective is consistent with preserving public confidence and may require discretion and confidentiality, which could be counter-productive to the transparency objective.

**Box 2 Country experiences**

In 2002, the Netherlands adopted the functional model. In the Netherlands, the prudential and financial stability functions are delegated to the central bank, De Nederlandsche Bank (DNB). The Dutch model acknowledges the close linkage between systemic stability and prudential supervision of the larger financial institutions. A separate supervisor, Autoriteit Financiële Markten (AFM), is responsible for the conduct of business standards. In a similar way, France merged its securities market supervisors, Commission des Opérations de Bourse (COB) and Conseil des Marchés Financiers (CMF), into one agency, the Autorité des Marchés Financiers (AMF) in 2003, while the prudential supervisors, the Commission Bancaire (CB) based at the Banque de France and the Autorité de Contrôle des Assurances et des Mutuelles (ACAM), merged into a single prudential supervisor, Autorité de Contrôle Prudentiel (ACP) linked to the Banque de France, in 2010. Italy has an objectives-based model of supervision, since the government changed the division of labour between CONSOB, the securities supervisor, and the Banca d’Italia (the Italian central bank) in 1999. In this new setting, CONSOB is responsible for transparency and proper conduct and the Banca d’Italia is responsible for prudential supervision of banks and securities firms as well as financial stability. The Banca d’Italia co-operates with the insurance supervisor, ISVAP.

The supervisory model in the US has also some features of the functional model (Padoa-Schioppa, 2003), although a sectoral orientation has been kept in place. The central bank is responsible for systemic stability and has extensive prudential supervisory responsibilities, while other agencies (notably the Securities and Exchange Commission
(SEC) and the newly created Bureau of Consumer Financial Protection) are entrusted with the task to protect the investor’s interests. The overall supervisory landscape in the US is fragmented with, for example, multiple supervisors for banks (the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation as well as state banking supervisors). The new Bureau of Consumer Financial Protection was introduced by the Dodd-Frank Act of 2010. Canada also applies the functional model with a prudential supervisor (OSFI) at the federal level and securities supervisors at the state level.

The integrated model started in Scandinavia in the late 1980s and early 1990s, while in the United Kingdom the Financial Services Authority was established in 1997. The consolidation of financial supervision in the UK was a response to the scattered framework of nine different supervisors with overlapping responsibilities (including the Bank of England and the Building Societies Commission for banking supervision, the Securities and Investments Board (SIB) with its multiple Self Regulatory Organisations for securities and conduct of business supervision, and the Department of Trade and Industry for insurance supervision). While the UK FSA was widely seen as the standard bearer of the single supervisor model, reform is underway to move to the twin peaks model (partly because of the lack of cooperation between the Bank of England and the FSA in the Northern Rock case). The prudential part will be moved to a new Prudential Regulation Authority, becoming a subsidiary of the Bank of England, and a separate Financial Conduct Authority.

Germany also used to have a sectoral framework: the Bundesaufsichtsamt für das Kreditwesen (in conjunction with the Bundesbank) was responsible for banking supervision, the Bundesaufsichtsamt für das Versicherungswesen for insurance supervision, and the Bundesaufsichtsamt für den Wertpapierhandel for securities supervision. These three supervisory agencies were merged into one agency, the new Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), in 2002. Similarly, a single supervisor, the Finanzmarktaufsichtbehörde, was established in Austria. In the German and Austrian version of the integrated model, the central bank has still some involvement in banking supervision.
5. New European financial supervisory framework

A key element in the design of the institutional framework for financial supervision is the appropriate level of (de)centralization. National supervisory agencies in the EU Member States are in charge of the supervision of financial institutions. Until recently, they co-ordinated their activities through European supervisory committees. The aim of these supervisory committees was to promote the convergence of supervisory standards and practices across the EU. While supervisors co-ordinated at the European level, they operated on the basis of a national mandate embedded in national legislation. This raised questions of efficiency and effectiveness. The three European supervisory committees had advisory powers and could only issue non-binding guidelines and recommendations. National supervisors of cross-border groups must co-operate within colleges of supervisors, but if they could not agree, there was no mechanism to resolve issues. Many technical rules were determined at Member State level, and there were considerable variation between Member States. Even where rules were harmonized, application could be inconsistent. This fragmented supervision undermined the Single Market, imposed extra costs for financial institutions, and increased the likelihood of failure of financial institutions with potentially additional costs for taxpayers.

Schüler and Heinemann (2005) have calculated the cost of fragmentation of financial supervision in the EU-15. Their results indicate increasing economies of scale in supervision. Comparing a structure with 15 national supervisors with a cost-efficient European supervisory framework, they predict cost savings of some 15 percent. Another drawback of national based supervision is the potential for conflicts of interest among national supervisors. While large cross-border financial institutions increasingly operate on an integrated basis with key decisions taken at head-quarters, supervisors are still examining the national parts of these institutions. The home supervisor as consolidated supervisor is coordinating the national supervisory efforts to minimize the potential for regulatory and supervisory arbitrage. The national supervisors also perform joint risk assessments of the large cross-border financial institutions, resulting in a joint supervision plan. But there are no legally binding mechanisms to deal with potential conflicts of national interest.

An example of a potential conflict is the distribution of capital (or liquidity) in a financial services group. The host supervisor may request full capitalization of the host subsidiary, while the home supervisor may request to maintain capital at the group level and to keep the capitalization of subsidiaries at the minimum level. Supervisors may also have diverging views on how to remedy shortcomings of a financial institution. Supervisors can easily settle on a joint action when they agree. But when there are (lasting) differences, the various supervisors all have the legal power to take enforcement action under their national mandate and this may result in sub-optimal outcomes.

These coordination problems pose the question of whether supervision should be done at the national level or at the European level. The basic argument in favor of moving to a European structure is that it might be difficult to achieve simultaneously an integrated and a stable financial system, while preserving a high degree of national-based supervision and crisis management with only decentralized efforts at harmonization.
(Thygesen, 2003). This is an application of the classical trilemma in monetary policy in which 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’.

A similar trilemma occurs in financial supervision (Schoenmaker, 2011a). Figure 2 illustrates the three incompatible objectives: 1. a stable financial system; 2. an integrated financial system; and 3. independent national financial supervision. An argument against moving to a European solution for financial supervision at the present time could be that the degree of financial integration does not yet justify such a move. However, as shown in De Haan, Oosterloo and Schoenmaker (2009), many financial markets (in particular wholesale markets) are almost fully integrated. The infrastructures to support financial markets are also integrating, albeit at a slower pace. There is also evidence for increasing cross-border penetration of banks and insurers. Emerging pan-European financial institutions give rise to cross-border externalities arising from the (potential) failure of these institutions. The increasing presence of financial institutions from other EU countries undermines the capacity of host authorities to manage effectively the stability of their financial system (see the chapter on the Role of Central Banks in Financial Stability, Schoenmaker 2011b).

**Figure 2. The financial trilemma**

1. Financial stability

2. Financial integration

3. National financial policies

*Source: Schoenmaker (2011a)*

**European Supervisory Authorities**

In October 2008 the European Commission mandated a High Level Group chaired by former managing director of the IMF Jacques de Larosière to give advice on the future of European financial regulation and supervision. The Group presented its final report on 25 February 2009 and their recommendation provided the basis for the new European financial supervisory framework.

The De Larosière Report (2009) concludes that the supervisory framework needed to be strengthened to reduce the risk and severity of future financial crises. The De Larosière Group recommends to create a European System of Financial Supervisors, comprising
three European Supervisory Authorities, one for the banking sector, one for the securities sector and one for the insurance and occupational pensions sector. Although the De Larosière Report (2009, p.48) mentions the twin peaks model (the functional model), it chooses to be neutral and adopts the sectoral model. As financial markets and institutions are operating on a cross-sector basis, it is regrettable that European supervision remains sectoral based. The High Level Group also recommends to establish a European Systemic Risk Board (see the next sub-section below).

Figure 3 illustrates the new European Supervisory Framework, which consists of a new European Systemic Risk Board (ESRB) and three new European Supervisory Authorities (ESAs) for the financial services sector: the European Banking Authority (EBA) based in London, the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt and a European Securities and Markets Authority (ESMA) in Paris. This framework provides the institutions to detect the risks at the European level which can accumulate across the financial system as we witnessed in the run up to and at the height of the financial crisis. The ESRB and ESAs started their work in January 2011.

The three new European Supervisory Authorities (ESAs) work in a network and in tandem with the existing national supervisory authorities (NSA) to safeguard financial soundness at the level of individual financial firms and protect consumers of financial services ("micro-prudential supervision"). The new European network combine nationally based supervision of firms with strong coordination at European level to foster harmonized rules as well as coherent supervisory practice and enforcement. The European Supervisory Authorities have the power to:

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5 The following Regulations provide the legal basis: the ESRB Regulation (1092/2010/EU), the EBA Regulation (1093/2010/EU), the EIOPA Regulation (1094/2010/EU), and the ESMA Regulation (1095/2010/EU).
- draw up specific rules for national authorities and financial institutions;
- develop technical standards, guidelines and recommendations;
- monitor how rules are being enforced by the NSAs;
- take action in emergencies, including the banning of certain products;
- mediate and settle disputes between national supervisors;
- ensure the consistent application of EU law.

Where necessary, the ESAs have the possibility of settling disagreements between national authorities, in particular in areas that require cooperation, coordination or joint decision-making by supervisory authorities from more than one Member State.

Mechanisms, such as Joint Committees, are introduced to ensure agreement and coordination between national supervisors of the same cross-border institution or in colleges of supervisors. For example, the EBA, the EIOPA and the ESMA are to form a Joint Committee (see figure 4) to oversee cooperation and coordination between national supervisors in the case of financial conglomerates.

**Figure 4. The European Supervisory Authorities work closely with the National Supervisory Authorities (NSAs)**

Following Schoenmaker and Oosterloo (2008), the new European System of Financial Supervisors will execute day-to-day supervision close to the financial institutions and markets under supervision. So, day-to-day supervision is done at national level, close to the ground, where appropriate expertise can be found. The new system is a "hub and spoke" type of network of EU and national bodies (Schoenmaker and Oosterloo, 2008). The new authorities act only where there is clear added value, and the areas where the authorities can act is strictly defined in European Regulations. The objective is for European and national bodies to work hand in hand. The new system has been designed in a way that it can be adapted to future developments in financial services. Every three years the European Commission will publish a wide-ranging report on the functioning of the new Authorities and assess whether further steps are needed to ensure the prudential
soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policyholders and investors. This may or may not lead to proposals to change the structures or tasks of the Authorities; any such proposal of the European Commission would have to be considered and adopted by the Council and the European Parliament.

Nevertheless, the ESAs may need to override national authorities in certain cases. The ESAs can address decisions directly to national authorities in three areas: (i) in cases where they are arbitrating between national authorities both involved in the supervision of a cross-border group and where they need to agree or coordinate their position; (ii) in cases where a national authority is incorrectly applying EU Regulations (EU Regulations are directly applicable and are not transposed into national law); and (iii) in emergency situations declared by the Council.

The authorities are able to take decisions directly applicable to financial institutions as a last resort in the three cases just referred to above where the Authority has addressed a decision to the national supervisor but the national supervisor has not complied with it. This can be done only in cases where there is directly applicable EU legislation as defined above. It is crucial that this mediation power is legally binding (Schoenmaker and Oosterloo, 2008). In that way, the ESAs can make their mark. Given that national supervisors know that the ESA can overrule them in cases of disagreement, they have an incentive to cooperate and agree among themselves.

The ESA will also have direct supervisory powers. The ESMA will have direct power for the supervision of credit rating agencies (CRAs). Since rating services are not linked to a particular territory and the ratings issued by a CRA can be used by financial institutions all around Europe, a more centralized system for supervision of Credit Rating Agencies at EU level has been proposed. Under the proposed changes, ESMA would be entrusted with exclusive supervision powers over CRAs registered in the EU. It would have powers to request information, to launch investigations, and to perform on-site inspections.

The Regulations establishing the new ESAs allow them to fulfill any other specific tasks, including supervisory tasks, conferred on them by EU Directives or Regulations. This may in particular be appropriate in the area of financial infrastructures. The Council and the European Parliament may thus in future grant further supervisory powers to the new ESAs where appropriate, on the basis of a European Commission proposal. A possible future task is the direct supervision of the largest cross-border banks and insurers by EBA and EIOPA. Examples of such large European banks and insurers include BNP Paribas, Deutsche Bank, ING, UniCredit, Allianz, AXA, and Generali.

An important ingredient of an effective financial supervisory framework is decisive action in emergency situations. The new ESAs have emergency powers – which would only apply in exceptional circumstances (defined as a situation which seriously jeopardizes the stability of financial markets). In the great majority of cases, the national and European level authorities will work hand in hand – sharing information, coordinating their work and taking decisions together (for example, on technical standards across the European banking sector so banks don’t have to comply with different standards in different countries).
Even in emergencies, the first objective of any of the three ESAs is to facilitate and coordinate actions by national supervisors, without binding decisions. However, if deemed necessary, there is a procedure in place for ESAs to address binding decisions to national supervisors requiring them to take the necessary action to safeguard the orderly functioning and integrity of financial markets and the stability of the whole or part of the European financial system. So, the new Authorities have an important co-ordinating role and are able to adopt decisions requiring supervisors to jointly take action.

The new Authorities also contribute to and participate actively in the development and coordination of effective and consistent recovery and resolution plans, guarantee schemes, procedures in emergency situations and preventative measures to minimize the systemic impact of any failure. The new Authorities should also ensure that they have a specialized and ongoing capacity to respond effectively to the materialization of systemic risks.

Finally, the ESAs have an elaborate Management Structure (see Figure 5). The Chairpersons of the new Authorities are appointed by the Boards of the Authorities composed of the Heads of national supervisors, and confirmed by the European Parliament, after a public selection procedure – based on a short-list prepared by the European Commission. The Chairpersons are full-time officials of the Authorities, but not representatives of any Member State or European Commission appointees. Nationals of any EU Member State with the required experience may apply.

It is clear that the Board of Supervisors with the ESA chairperson and 27 heads of NSAs is too large to work smoothly. A Management Board of only 6 heads of NSAs is therefore created to perform certain tasks. An executive director runs the organization.

**Figure 5. The Management Structure of the ESAs**

![Management Structure of the ESAs](image)

*European Systemic Risk Board*

According to De Larosière Report (2009), a key lesson to be drawn from the crisis is the urgent need to upgrade macro-prudential supervision in the EU for all financial activities. In the report of the High Level Group, it is stressed that central banks have a key role to play in a sound macro-prudential system. However, in order to be able to fully play their
role in preserving financial stability, they should receive an explicit formal mandate to assess high-level macro-financial risks to the system and to issue warnings where required.

The High Level Group recommends establishing a new independent body, the European Systemic Risk Board (ESRB), responsible for safeguarding financial stability by conducting macro-prudential supervision at the European level. The ESRB includes the members of the ECB General Council plus the Chairs of the three ESAs (EBA, ESMA, EIOPA) and a member of the European Commission. To ensure appropriate geographical coverage and a well-balanced composition, the De Larosière Report proposes ECB involvement via the ECB General Council, which includes the President of the ECB, the Vice-President of the ECB, and the governors of the NCBs of all 27 EU Member States, rather than that of the Governing Council (which includes only the euro-area members).

The main task of the ESRB is to make assessments of stability across the EU financial system in the context of macro-economic developments and general trends in financial markets. In case of significant stability risks, the ESRB provides early warnings and, where appropriate, issues recommendations for remedial action. The addressees of warnings and recommendations are subsequently expected to act on them unless inaction can be adequately justified (see the chapter on the Role of Central Banks in Financial Stability, Schoenmaker 2011b, for further details on the ESRB).

Assessment
The EU has adopted an evolutionary approach towards establishing a truly European supervisory framework. Academics are debating whether the glass is half empty (that is the national supervisors are still in charge) or half full (that is we are heading for a growing role of the ESAs). There are some pointers towards the latter. First, the ESAs have a legally binding power of mediation. Given that the ESA has the final say, game theory suggests that the national supervisors are expected to fall in line. National supervisors will want to avoid being overruled by the ESA. If that happens too often, their reputation will be hurt. Second, the ESAs have direct powers in emergency situations. Third, new tasks can be transferred from the national supervisors to the ESAs. Time will tell how often this provision of the Regulations will be invoked.
6. Conclusions

Financial supervision in the European Union (EU) has undergone a major reform. With the establishment of the new European Supervisory Authorities (ESAs), the balance seems to be shifting from national supervision to EU based supervision. But day-to-day supervision remains with the national supervisors. So, they remain in the hot seat. Nevertheless, the chairs of the ESAs have some important mediation powers as well as special powers in emergency situations. It is to be expected that powers will move slowly to the emerging central bodies. Time will tell.

The EU has chosen a sectoral approach for the new ESAs. This is a missed opportunity. EU Member States are moving from sectoral based to cross-sector models in response to the cross-sector nature of financial markets and institutions. The first cross-sector model is the functional or twin peaks model with a micro-prudential and a conduct of business supervisor. As central banks are receding their monetary power to the ECB, they are happy to combine macro-prudential supervision (financial stability) and micro-prudential supervision. The emerging structure for several euro-area countries is a twin peaks model with the central bank responsible for micro-prudential and a separate financial market authority for conduct of business. The second cross-sector model is the integrated supervisory model. Scandinavia has pioneered the integrated supervisory model followed by the UK. But the UK is now moving to a twin peaks structure.

The new European Financial Supervisory Framework has just started in January 2011. It would be interesting to see the new system evolving. Particular areas of attention include:

- the cooperation within the networks between the centre (ESA) and the national supervisory agencies (NSAs);
- the cooperation between the three ESAs;
- the cooperation between the ESAs and the ESRB;
- the assignment of new tasks for the ESAs.

A major new task for the ESAs would be the direct supervision of the large European banks and insurers. A two tier system could evolve with the large cross-border financial institutions supervised at the European level and the smaller domestic ones at the national level. But that is not to be expected in the very near future.
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