Does Europe need a Euro-wide supervisor?

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Integration in the financial industry, both across borders and across sectors, has led to the emergence of an almost seamless financial industry. These market developments have implications for the organisational structure of supervision and crisis management as well as the political accountability for supervision and financial stability in the European Union.

There is a great deal of agreement that a desirable evolution is taking place from sectoral to functional or integrated supervision, and that the international component in supervision should increase. At the same time, there is a great deal of disagreement about the preferred end-model for Europe. Policy recommendations vary from enhanced cooperation to setting up a centralised structure at the European level, for which a treaty change could be negotiated at the next intergovernmental conference in 2004.

Alternative supervisory models
Table 1 shows different possible supervisory structures at national and Europe levels. At present, most EU countries operate either integrated (third column, e.g. UK, Scandinavia) or sectoral regimes (some, like Portugal with additional arrangements to strengthen cross-sector cooperation). The Netherlands is moving toward the middle column, which also represents aspects of Italy and France. The present European structure is based on a mixture of cooperation and coordination and on sectoral committees (first column, rows A/B), with a marginal arrangement to strengthen cross-sector cooperation (Pearson).

The ‘grand’ solutions for Europe
There are two basic questions regarding the end-model or the ‘grand design’ for the organisational structure of supervision in Europe:
• Would it be desirable or manageable to move from the present European structure to a centralised system (row C)?
• If so, which of the various models within row C (sectoral/functional/integrated) should be chosen?

Both questions are controversial. The basic argument for a centralised structure – and opening treaty negotiations in the same vein as the negotiations on the Maastricht Treaty for EMU - is that it might be difficult to achieve simultaneously a single financial market (on a fast track) and stability in the financial system, while preserving a high

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1 This paper presents an overview of debates at a recent conference on financial supervision in Europe organised by the Netherlands Ministry of Finance. The views in this paper are of the authors and not necessarily of the Netherlands Ministry of Finance. The first author is also with Erasmus University Rotterdam (OCFEB).
This table illustrates alternative supervisory structures at national and European levels. Columns show national arrangements. Rows show possible corresponding European arrangements.

Cooperation means decision-making by consensus. Coordination means international decision-making by autonomous national decision-makers according to some sort of rule (e.g. majority voting). A centralised solution implies that supervision is organised on a European basis, with decisions about regulation and supervisory policy taken at European rather than national level. This does not necessarily imply a transfer of a large part of national supervisory resources (including staff) to the central level, given that supervision is a microeconomic policy and that the execution of supervision takes place close to the supervised institutions.

<table>
<thead>
<tr>
<th>National arrangements for supervision</th>
<th>European arrangements for supervision</th>
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<tr>
<td><strong>1. Sectoral</strong>&lt;br&gt;Separate supervisors for banking, insurance and securities business e.g. Portugal</td>
<td>A. Decentralised &amp; cooperation&lt;br&gt;Cooperation in sectoral committees</td>
</tr>
<tr>
<td><strong>2. Cross sector: functional</strong>&lt;br&gt;Separate supervisors for prudential supervision and conduct of business supervision e.g. Netherlands proposal</td>
<td>A. Decentralised &amp; cooperation&lt;br&gt;Cooperation in functional committees</td>
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<td><strong>3. Cross sector: integrated</strong>&lt;br&gt;Single supervisor for banking, insurance and securities combined e.g. UK</td>
<td>A. Decentralised &amp; cooperation&lt;br&gt;Cooperation between national FSA's</td>
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<tr>
<td>C. Centralisation&lt;br&gt;Separate European banking, securities and insurance supervisors</td>
<td>E. European securities regulator&lt;br&gt;European FSA</td>
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degree of national regulation and supervision with only decentralised efforts at harmonisation (Thygesen). Arguments against moving to a centralised solution at the present time are that the degree of integration in financial markets does not yet justify such a move and that other preconditions have not yet been fulfilled, e.g. that the issue of political legitimisation must be settled and financial regulation should be harmonised first (Caspari).

As regards the second question, one argument in favour of a cross-sector solution (Columns 2 and 3) would be the disappearance of sectoral boundaries within the financial sector. In principle, all models should provide for close links between the prudential or banking supervisor and the central bank, which is responsible for financial stability. This link might be especially important in EMU, since the integration of payments systems could lead to an increase in systemic risk across borders. Central banks are the first to detect these kinds of problems and access by central banks to supervisory information is crucial in these circumstances.

It is unlikely that a consensus will emerge in the near future as regards the need for and the shape of any ‘grand design’. Even if there were such consensus, the existence of different national supervisory structures complicates the emergence of an unequivocal system of supervisors at the European level. Hence, pragmatic solutions for the supervisory structure in Europe point towards some “competition” between national models for the time being, coupled with efforts to improve coordination (i.e. solutions within row B). Moreover, such “competition” is better than a poor compromise.

**Pragmatic solutions**

The dynamic process of “competition” between national models might, according to Gros, evolve as follows. Countries with less developed or less competitive financial sectors (and possibly less developed supervision) might tend to protect their institutions from international competition and takeovers. Such countries may tend toward the national solution. On the other hand, supervisors of countries with competitive financial markets may be less inclined to protect their national mandate and more willing to accommodate integration. Once a clearer picture of national best practices emerges, these countries might take a lead in pursuing a more centralised solution. In this view, Europe is not yet ready for such a more centralised structure, and forcing the pace of negotiations risks producing a compromise that could be suboptimal in a longer-term perspective.

As regards the ‘pragmatic’ policy initiatives to strengthen cooperation and coordination, a number of ideas have emerged from the conference (e.g. Vesala):

- Current memoranda of understanding between supervisors should be improved where possible by making them more explicit and publicly available;
- Convergence in supervisory practices should include the harmonisation of reporting requirements for financial institutions. An example of such a harmonised report is the call report (reporting form for banks) in the United States developed by the Federal Financial Institutions Examination Council;
- In line with the second recommendation, there should be pooling of information on large international financial institutions;
- There should be benchmarking of regulation and supervision based on best practices in terms of efficiency and effectiveness. Furthermore, regulatory arbitrage opportunities across borders and across sectors should be addressed.

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2 The purposes of the FFIEC, established by statute in 1978, are to prescribe uniform federal principles and standards for the examination of depository institutions, to promote coordination of banking supervision among the federal agencies that regulate financial institutions, and to encourage better coordination of federal and state regulatory activities (The Federal Reserve System: Purposes and Functions, 8th edition, 1994, Board of Governors of the Federal Reserve System, Washington D.C.).
Our own position
So what is our own position in the debate? We believe that it is time to discuss the issue, but too early to be definitive about the need for, or possible shape of, a ‘grand design’ for the organisational structure in Europe. Therefore, options should be kept open as regards possible end-models particularly, given the cross-sector trend, B/C2 (functional) and B/C3 (integrated). Current policy initiatives should be undertaken with an appreciation of whether they are compatible with these end-models. In our opinion, any sort of European system of supervisors will in any case need to have the following properties:
• It should reflect the state of integration across sectors and across borders in Europe;
• Policy rules (e.g. the rulebook and reporting requirements for institutions under supervision) and information pooling might at some stage and in some form be centralised, but supervision should be executed at the local level where the institutions are based. For transnational institutions, the ‘lead supervisor’ should remain located near the head office of the financial institution3;
• The system of supervisors should use an integrated computer system, so that confidential information can be aggregated and shared on line and in real time. This will allow effective market surveillance of systemic risks (including a peer group analysis of large institutions).

As regards the process, we believe that some degree of “competition” between models would highlight their strengths and weaknesses. This process would be enhanced by benchmarking based on best practices and by peer review of each other’s system as recommended in a different context by Lamfalussy. Currently, national models are moving in the direction of a functional or integrated organisational structure, while the European structure – both in legislation and committee structures – is still based on sectoral cooperation. This suggests that the European structure also needs to move to the right (column 2 or 3) in rows A/B of table 1.

“The danger is that - in the event of a crisis at a transnational institution - no country would be willing to pay the costs for crisis management by itself”

3 In this system, there would be several possibilities regarding the supervision of foreign branches and subsidiaries. One possibility would be to maintain the present system of home country control, in which the home country supervisor is responsible for supervision of branches that are located in host countries. Another possibility would be that both foreign branches and subsidiaries become subject to local supervision (or supervision by a team that consists of both home and host supervisors). This possibility addresses the criticism of home country supervision that it could lead to supervision at too great a distance from the institution under supervision.

Crisis management and political accountability
The question of the organisational structure of supervision also has implications for crisis management in Europe. Apart from the prudential supervisor, at the national level the central bank and the ministry of finance can also become involved in crisis management. As regards the instruments of crisis management, private-sector solutions are preferable (see below). If private-sector solutions cannot be brokered or do not suffice, public support may be needed. National central banks act as a lender of last resort and are responsible for liquidity.
support. In the unlikely case of solvency support, ministries of finance would be responsible.

In the centralised solutions as classified in row C, the ECB might become responsible for lender-of-last-resort support for transnational institutions and supposedly the Council of Ministers of Finance (EcoFin) would need to decide on possible solvency support. This shows that, again, a distinction must be made between ‘pragmatic’ and ‘grand’ solutions for Europe.

**Crisis management in the EU**

At present, the home country is responsible for prudential supervision of financial institutions in the EU. Financial institutions are able to operate through the EU on the basis of a single license and there is no separate licensing by the host authorities of branches, although this is the case for subsidiaries. There are no specific references to crisis management in the EU directives, but the presumption is that the home country authorities are responsible for decisions on crisis management regarding an individual institution and its branches.

The present organisational structure for crisis management in the European Union has been reviewed in the ‘Report on Financial Crisis Management’\(^5\). The guiding principles are that the instruments of crisis resolution are available at the national level and that the costs are borne at the national level. As regards the instruments for crisis management, there is a strong preference for private-sector solutions as opposed to public intervention tools. The report calls for enhanced cooperation to deal with the consequences of financial market integration.

**“Improvised cooperation”**

The present system for international crisis management in the EU has been labelled as “‘improvised cooperation’” (Freixas). The danger is that in the event of a crisis at a transnational institution - no country would be willing to pay the costs for crisis management by itself, since the home country would bear the full cost but would not be responsible for systemic stability in other countries. Furthermore, ex ante loss-sharing arrangements between countries would not be politically feasible at this moment. These two elements would result in an undersupply of bailouts. Therefore, the policy recommendation would be to improve ‘firewalls’ as regards capital regulation and the level of collateral in payment systems to prevent crises.

Many contributors to the conference furthermore pointed to the need for clear procedures for crisis management. They point out that there should be ‘constructive ambiguity’ regarding the availability of public support in individual cases to reduce moral hazard. However, ambiguity about the procedures and responsibilities is not seen as constructive, as it reduces confidence, accountability and possibly the effectiveness of crisis management.

**Crisis management: from cooperation to coordination?**

In terms of table 1, the present EU structure for crisis management is founded on the principle of cooperation (row 1). The organisational structure for crisis management in the EU is therefore less developed than the organisational structure for supervision in the EU, which is largely based on coordination (row 2). The calls for ‘enhanced cooperation’ and clearer procedures in crisis management imply that at some stage a move from cooperation in the direction of coordination in crisis management may become desirable. So if we were to reduce ambiguity about the procedures for international crisis management in the EU and move from cooperation towards coordination, what could such a structure look like and what should be its aim?

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4 In practice, liquidity and solvency problems cannot always be distinguished and central banks and ministries of finance need to cooperate when a financial institution is facing problems.

5 Report on Financial Crisis Management (April 2001), Economic and Financial Committee. This report is also known as the second Brouwer report.
In an individual country the central bank, the supervisor (possibly part of the central bank) and the ministry of finance could potentially be involved in crisis management. On an international level, crisis management would also include the ECB and possibly the European Commission, meaning that coordination between n countries would involve up to 3n + 2 players at the table (Goodhart). Could such a committee really be effective? There is a precedent in European history for speedy confidential decision-making by many international players. In the former European Monetary System, confidential decision-making on realignments took place over the weekend by ministers of finance, central bankers and the European Commission. The rules of procedure of this committee - including the decision-making rule - could serve as a starting point for thinking about the development of a European structure for crisis management.

As regards the aims of crisis management, it should be remembered that, in line with the principle of subsidiarity, only issues that cannot be solved at the national level, should be dealt with at EU level. As has been emphasised in many cases, every crisis is unique and there is no ‘blueprint’ for crisis resolution. The ‘toolkit’ for crisis management contains a wide range of instruments, which need to be tailored to the situation at hand. This implies that such a possible committee should only address the problems that arise in a European context: the home supervisor might not have the right incentives to weigh the effects on financial stability in host countries. Therefore, a committee on crisis management could discuss the policy reaction to possible problems with implications in several countries. Furthermore, if there were a crisis of a systemic nature, affecting many institutions in many countries at the same time, such a committee could discuss the broad balance between the instruments used in different countries (for example ensuring that private-sector solutions are indeed applied where possible).

**Conclusion**

To sum up we would like to quote the contribution of John Mogg, Director General of Internal Market at the European Commission, to the conference. Speaking personally he noted:

“A possible future discussion on a single supervisory authority will have to touch on a number of sensitive political questions: should it be responsible for all institutions, including all 10,000 banks in the EU? What about resources – there are around 16,000 banking supervisors in 15 member states? Should authorities be separate or integrated in respect of banking, securities and insurance? What role should the national authorities play? To whom would the single authority be accountable? How would its head be appointed? The lack of answers to these questions and the sheer complexity of these issues is one of the reasons why the discussion has not started at the political level…

“...Will the ECB be the lender of last resort? Should this be a concern of the Eurozone member states only? If so, how should financial activities in the non-Eurozone be reconciled with those in the Eurozone? Who should be politically accountable in the case of bailouts? While there are no answers to these questions, these are the right questions. Another critical question is: when do we need the answers?”

At the present stage, negotiations on a European system of supervisors would be
On June 20 this year, the Ministry of Finance of the Netherlands organised the conference ‘Financial Supervision in Europe: Issues on Political Accountability’. This article draws on the presentations and comments made at the conference by, among others: Ingo Walter (New York University), Anton van Rossum (Fortis, European Round Table of Financial Services), Patrick Pearson (European Commission), Jukka Vesala (European Central Bank), Daniel Gros (Centre for European Policy Studies), John Mogg (European Commission), Xavier Freixas (Universitat Pompeu Fabra, Barcelona), Robin Fellgett (H.M. Treasury, United Kingdom), Garry Schinasi (International Monetary Fund), Charles Goodhart (London School of Economics), Karl-Burkhard Caspari (Bundesministerium der Finanzen, Germany), Niels Thygesen (University of Copenhagen).

The authors would like to thank all of the participants of the conference for their contributions. A conference volume will be published next year by Edward Elgar Publishing Ltd.

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