Financial Supervision in Europe: 
A Proposal for a New Architecture 

Dirk Schoenmaker and Sander Oosterloo
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 national monetary policy. Only two out of the three objectives can be pursued at the same time, 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.

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The integration of financial markets is thus the key driver for possible changes. In particular, the capacity of the financial services groups to span different EU financial markets fosters integration. Emerging pan-European banks and insurers give rise to cross-border externalities arising from the potential failure of these banks (and insurers). The increasing presence of financial groups from other EU countries undermines the capacity of host authorities to manage effectively the stability of their financial system. Host authorities are thus dependent on the action, or lack of it, of home authorities. Moreover, increased linkages between banks, insurers and pension funds may raise the potential vulnerabilities of the wider European financial system. If these trends continue, it may become necessary to give up the third objective of the trilemma: national financial supervision and crisis management. To maintain

\[\text{The opinions in the paper are those of the authors and not necessarily those of the Netherlands Ministry of Finance.}\]
the stability of an integrated EU financial system, arrangements for financial supervision and stability may have to be anchored at the EU level.

This chapter identifies 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. New evidence on emerging pan-European banks and insurers is provided. We are moving from a landscape with primarily domestically operating financial firms to a small group of large European-wide operating financial firms. Some of these large firms even operate on a global scale.

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 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, policymakers 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 chapter, we propose a prospective European System of Financial Supervisors to be created by a European Financial Agency 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. **Current supervisory arrangements**

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.\(^2\) 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).\(^3\) 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).\(^4\) A broader use of group supervision is discussed in the negotiations on a new supervisory regime for insurance (Solvency II).

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

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\(^2\) 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).

\(^3\) Financial Conglomerates Directive 2002/87/EC.

\(^4\) Insurance Groups Directive 98/78/EC.
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 for supervision and host country responsibility for financial stability is sustainable in an integrating market.

3. **Industry developments**

3.1 **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. The level of cross-border penetration within Europe is gradually increasing from 11 percent in 1995 to 18 percent in 2005 (Figure 2). Cross-border penetration is measured as the share of business of banks from other EU countries as a percentage of a country’s total banking assets. This quantity based integration measure suggests that banking integration is progressing. Looking at the country level, it is clear that the degree of cross-border penetration is uneven across Europe. Table 1 provides an overview of cross-border penetration in the different countries. While the accession countries have experienced a strong inflow from West-European banks (60 percent of total banking assets in the NMS-10), the cross-border penetration is more limited at 17 percent in the EU-15. Within the latter group, Luxembourg has a strong presence of EU banks, which is primarily driven by a favourable tax-regime. France, Germany, Italy, the Netherlands and Sweden have a low degree of cross-border penetration (less than 10 percent).

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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 8,684 credit institutions in the EU are 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 Schoenmaker and Oosterloo, 2005; Hartmann, Straetmans and De Vries, 2006).

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 unweighted 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 3 shows that the internationalisation of the banking sector is increasing. The number of international banks (European and Global banks) increases from 12 in 2000 to 14 in 2005. It is interesting to see that within the group of International banks, the number of European banks increases (from 7 to 11), while the number of Global banks decreases (from 5 to 3). 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 six year period (2000–2005), a statistically significant upward trend of emerging European banking groups is found.

Figure 4 depicts the geographical segmentation of the top 25 European insurance groups from 2000 to 2005. The top 25 insurance groups is based on the top 25 composed by the Comité Européen des Assurances (2007) and ranked on the basis of total group premium.
indicates that the insurance industry is very internationally oriented. About half of these 25 large insurance groups have an international focus in 2005. 13 out of the sample of 25 insurance groups operate on an international scale (more than 50% of their business abroad). Of this international group, 10 operate on a European scale (more than 25% of their business in the rest of Europe). Cross-border insurance is thus wide spread in Europe among the large insurers.

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.

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3.2 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 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 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, 2006; Schoenmaker and Oosterloo, 2007). 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.

Summing up, we see two diverging industry trends:

1. 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;
2. 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.

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. First, how to deal with integrated financial groups? Second, 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.
We develop three criteria to judge the different policy options. The first criterion is effectiveness of the arrangements for financial supervision and stability. More precisely, could the arrangements take an EU-wide view? The second criterion is efficiency. Efficiency implies no duplication by supervisors. Supervisors should also operate as closely as possible to the supervised institution to know what is really going on. The third criterion is level playing field. The Single Financial Market promotes a level playing field. While the EU regulatory framework (Directives and Regulations) is largely harmonised, a real level playing field would only be achieved by a consistent and common application of the harmonised rules by the supervisors.

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 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 that works in tandem with the national supervisors: some form of a European System of Financial Supervisors. There are two basic forms. First, the central agency in the System is responsible for prudential supervision of cross-border financial groups at the European level. This central body will be given full responsibility for the EU-wide operations, both branches and subsidiaries, of pan-European financial groups. Second, the role of the central agency is to foster cooperation and consistency
among members of the System, but leaves the day-to-day supervision of cross-border financial groups with the consolidating or lead supervisor.

4.1 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 tables 11 and 13 in ECB, 2006). 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 supervisor 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.\(^5\) 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.\(^6\) 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

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\(^5\) 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).

\(^6\) This is consistent with Goodhart, Schoenmaker and Dasgupta (2002), who also find evidence for economies of scale in supervision.
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 underprovision of public goods, that is, to an insufficient level of bailouts.

4.2 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 delay decisions of the lead supervisor. As the role and the powers of the host supervisor in these colleges are non-committal, 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).

\[7\] 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.
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.

4.3 A European System of Financial Supervisors

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 Agency (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 5). 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.

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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. 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 (2004) 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.\footnote{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.}

In our view a decentralised European System of Financial Supervisors could combine the advantages of a European framework with the expertise of local supervisory bodies (Schoenmaker and Oosterloo, 2007). One could think of a European System of Financial Supervisors with a body at the centre (European Financial Agency) working in tandem with the 27 decentralised national auxiliary branches (see figure 6). In such a system:

- Small and medium-sized banks which are primarily nationally oriented, are supervised by one of the 27 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. 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 European Financial Agency. If necessary, the European Financial Agency 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 Agency (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 of the European Financial Agency and the Chairmen of the 27 National Teams (in the same way as the ESCB takes decisions on monetary policy). 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 27 national teams close to the financial firms. The European Financial Agency will be responsible for information pooling and is therefore best equipped to perform EU-wide peer group analysis of large European financial groups.

- The European Financial Agency is responsible for the correct and uniform application of supervisory rules (level playing field) and it can also act as a mediator in case of problems between home and host country authorities. In doing so, it may give instructions to the 27 national teams. This mediation role for the European Financial Agency could evolve from the mediation mechanisms which are currently set up for the European supervisory

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9 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.”

10 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.
committees at level 3 (FSC, 2005).

- Accountability is an important element of the System. On behalf of the European System of Financial Supervisors, its chairman 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 chapter 11 in Lastra, 2006, 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.

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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 discretions. In contrast, EU Regulations have a direct application throughout the EU and thus establish a uniform 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 Agency (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 (2007) 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 authority. 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 (ESCB) 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. The route towards the creation of the ESCB was in different stages. The Committee of EU Central Bank Governors (stage 1) was turned into
the European Monetary Institute (stage 2) to prepare the ground for a single monetary policy. The EMI was subsequently turned into the ESCB comprising of the European Central Bank at the centre and the national central banks of the participating countries (stage 3). In a similar vein, a European System of Financial Supervisors could evolve from the current European supervisory committees at level 3 (Schoenmaker, 2005).

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. Goodhart and Schoenmaker (2006) explore possible *ex ante* mechanisms for fiscal burden sharing in a banking crisis in Europe. The first mechanism could be a general fund to shoulder the burden of recapitalisation. This general fund could be financed directly by the participating countries, which would pay their relative share (e.g. based on GDP) in the fund. The main advantage of this system is that the cost of recapitalisation is smoothed over countries. There are, however, serious problems with this approach, not least that there is little (political) enthusiasm for cross-border fiscal transfers. The second mechanism involves specific burden sharing. In this scheme, only countries in which the problem bank is conducting business contribute to the burden sharing. A country’s contribution can be related to the share of the problem bank’s business in that country. In this way, cross-border transfers are largely avoided. Both schemes are subject to the free-rider problem. Countries that do not sign up to burden sharing nevertheless profit from burden sharing, as the stability of the European financial system is a public good. 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.

5. **Conclusions**

Supervisory structures should, in our view, adapt to market developments and not the other way round. The chapter 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 completion of the Financial Services Action Plan and the advance to EMU. 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 is 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 Agency 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 are done at the centre (governed by a council with executive directors of the new European Financial Agency and the chairman of the national supervisors). In this way, host country authorities are fully involved and the interests of their depositors are 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 supervisory committees can form the nexus for a new European System of Financial Supervisors. The next 5 years we expect further discussions on the desirability and workings of a putative European System of Financial Supervisors and then 5 years to implement a new System. Market developments will no doubt dictate the exact speed of the evolution.
References


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Figure 1. The trilemma in financial supervision

1. Stable financial system
2. Integrated financial market
3. National financial supervision
Figure 2. Cross-border penetration in European banking

Sources: Authors’ calculations based on Report on EU Banking Structure (ECB, 2004) and EU Banking Structures (ECB, 2006).
Note: Share of assets from EU countries measured as a percentage of total banking assets. The share is calculated for the EU as a whole.
Figure 3. Classification of top 30 EU banks

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 4. Classification of top 25 EU insurers.

Notes: National insurers conduct more than 50% of business in the home market. International insurers (more than 50% of business abroad) are divided into European insurers (more than 25% of business in other European countries) and global insurers (less than 25% of business in other European countries).
Figure 5. A Centralised European System of Financial Supervisors: The Breuer Model

EFA = European Financial Agency
NTs = National Teams
Figure 6. A decentralised European System of Financial Supervisors (ESFS)

EFA = European Financial Agency
NTs = National Teams
ESFS = European System of Financial Supervisors (EFA and 27 NTs)
Governing Council = Executive Board and Chairmen of 27 National Teams
## Table 1. Cross-border penetration of banking at the country level (2005 figures)

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of banks</th>
<th>Total banking assets (in EUR bn)</th>
<th>Business from domestic banks (in %)</th>
<th>Business from EU countries (in %)</th>
<th>Business from third countries (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>880</td>
<td>721</td>
<td>80</td>
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<tr>
<td>Belgium</td>
<td>100</td>
<td>1,055</td>
<td>77</td>
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<td>2</td>
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<td>60</td>
<td>72</td>
<td>22</td>
<td>5</td>
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<td>56</td>
<td>105</td>
<td>7</td>
<td>89</td>
<td>5</td>
</tr>
<tr>
<td>Denmark</td>
<td>197</td>
<td>722</td>
<td>79</td>
<td>19</td>
<td>2</td>
</tr>
<tr>
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<td>11</td>
<td>12</td>
<td>1</td>
<td>99</td>
<td>0</td>
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<tr>
<td>Finland</td>
<td>363</td>
<td>235</td>
<td>42</td>
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<tr>
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<td>5,090</td>
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<td>10</td>
<td>1</td>
</tr>
<tr>
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<td>9</td>
<td>1</td>
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<tr>
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<td>75</td>
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<td>57</td>
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<tr>
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<td>9</td>
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</tr>
<tr>
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<td>47</td>
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<tr>
<td>Lithuania</td>
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<td>75</td>
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<tr>
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<td>792</td>
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<td>Malta</td>
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<tr>
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<tr>
<td>Sweden</td>
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<td>653</td>
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<td>9</td>
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<tr>
<td>United Kingdom</td>
<td>400</td>
<td>8,320</td>
<td>48</td>
<td>26</td>
<td>26</td>
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<tr>
<td><strong>EU-15</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total EU-15</td>
<td></td>
<td>7,105</td>
<td>32,356</td>
<td>75</td>
<td>17</td>
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<tr>
<td><strong>NMS-10</strong></td>
<td></td>
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<tr>
<td>Total NMS-10</td>
<td></td>
<td>1,579</td>
<td>526</td>
<td>35</td>
<td>60</td>
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<tr>
<td><strong>EU-25</strong></td>
<td></td>
<td>8,684</td>
<td>32,882</td>
<td>74</td>
<td>18</td>
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</tbody>
</table>

Source: EU Banking Structures (ECB, 2006).

Notes: Share of business from domestic banks, share of business of banks from EU countries and share of business of banks from third countries are measured as a percentage of the total banking assets in a country. The shares add up to 100%. Figures are for 2005. EU-15, NMS-10 and EU-25 are calculated as a weighted average (weighted according to assets).