A debate on the most appropriate structure for financial supervision has been initiated in Europe. The reasons are manifold and relate not only to the transfer of monetary policy-making powers to the ECB and the role this institution will play in financial supervision, which is a national responsibility at present anyway. In several member states, financial conglomerates have become the dominant players, posing a challenge to supervisors of all disciplines in the exercise of effective control. At the same time, financial products have become increasingly complex, combining features of different disciplines, whose supervision requires new and enhanced skills. Against this background, the traditional functional division of financial sector supervision looks increasingly outdated.

Other problems are emerging as a result of increased market integration, which has been stimulated by EMU and the establishment of the single market. European financial market liberalisation is based on the principle of home country prudential control. Strictly speaking, the increasing size and scope of large cross-border financial groups should not affect this rule, but it is debatable how far this principle can continue to be applicable. The demand will also grow for further rationalisation and standardisation of the methods of supervision, to simplify pan-European operations and to reduce their costs. European groups that are active in different member states today face multiple reporting requirements, supervisory techniques and hence costs. If cross-border financial sector consolidation is to be encouraged in Europe, this issue will need to be tackled as well.

Efforts to introduce reforms at national level have, to varying extents, led to more horizontal or cross-sectoral approaches in financial supervision. At the extreme end, some states have merged the different areas of financial sector supervision within a single authority, thereby introducing a radical supervisory redesign based on the objectives of supervision, while others have provided for structures of cross-sectoral supervisory cooperation of varying degrees of formality.

The purpose of this paper is to extend this discussion to the European level and to examine what changes are required to bring about an integrated financial market. There is clearly an awareness that things need to be adapted at European level, as reflected in the European Commission’s Financial Services Action Plan as well as in statements by various regulators and by members of the ECB. But the debate has only begun.

We start in Section I with an analysis of the changes that have taken place in the European financial system. The second section examines the institutional structure of financial supervision at the national level. Section III discusses the European angle of this design, the current provisions, the role of the ECB, and the required changes in the institutional structure to accommodate growing market integration.

I. The European financial system in evolution

Europe’s financial system remains firmly based on banking institutions. Banks play a much more dominant role in Europe than they do in the US, where bond and equity markets are more developed. The asymmetry between the two systems results largely from different regulatory
preferences: Europe adopted universal banking as its model, whereas the US financial system was defined by the 1933 Glass-Steagall Act, which separated commercial from investment banking. The US regime stimulated tough competition between intermediaries and provided the environment in which capital market financing, specialisation and innovation flourished. Under the EU’s single market rules, banks are allowed to combine their commercial and investment banking activities under a single roof, which further stimulates bank financing.

European financial market liberalisation and the creation of the single market started a process of restructuring and scale enlargement in European banking, which is being further advanced by EMU. The number of banks is falling and concentration is increasing. The total assets of EU-based banks continue to grow. They went up from 177% of GDP in 1985 to reach 215% of GDP in 1997 (OECD, 1999). Total assets of US commercial banks remained stable and stood at 57% of GDP in 1997. During the same period, securitisation increased dramatically in the US, but only very moderately in Europe (BIS, Quarterly Review, June 1999).

At the same time, a tendency towards conglomeration started in European finance. In contrast to the US, where the 1965 Bank Holding Company Act restricted links between banks and non-bank financial corporations, no such limitations are in place in Europe. Although bank and insurance companies need to be separately incorporated, nothing prohibits their falling under the control of a single holding company. Data on mergers and acquisitions in financial services in the US and Europe document this process (see Table 1). In Europe, close to one-third of all deals (29.7%, and 7% bank-insurance) in the financial services sector in the period 1985-99 were cross-sector, whereas this was 17% in the US (and 7.0% for bank-insurance). The US figure is heavily influenced by the Citicorp-Travellers merger, as suggested by the fact that it was 15.4% for the period 1985-97 (and only 0.2% for bank-insurance). Mergers and acquisitions among banks in the same period represent close to half of all financial sector deals in the US, compared to 36.2% in Europe.
### Table 1. Mergers and Acquisitions in the financial services sector, 1985-99 (total value, billions of $)

#### Domestic M&As

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Securities</th>
<th>Insurance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>475</td>
<td>24</td>
<td>0.3</td>
<td>499.3</td>
</tr>
<tr>
<td>Securities</td>
<td>6</td>
<td>111</td>
<td>32</td>
<td>149</td>
</tr>
<tr>
<td>Insurance</td>
<td>73</td>
<td>16</td>
<td>153</td>
<td>242</td>
</tr>
<tr>
<td>Total</td>
<td>554</td>
<td>151</td>
<td>185.3</td>
<td>890.3</td>
</tr>
</tbody>
</table>

| Cross-sector as % of total | 17.0 |
| Bank-insurance as % of total | 8.2  |

#### Cross-border M&As

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Securities</th>
<th>Insurance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>32.1</td>
<td>7.4</td>
<td>0.2</td>
<td>39.7</td>
</tr>
<tr>
<td>Securities</td>
<td>5.7</td>
<td>25.2</td>
<td>6</td>
<td>36.9</td>
</tr>
<tr>
<td>Insurance</td>
<td>0.6</td>
<td>4.1</td>
<td>62.6</td>
<td>67.3</td>
</tr>
<tr>
<td>Total</td>
<td>38.4</td>
<td>36.7</td>
<td>68.8</td>
<td>143.9</td>
</tr>
</tbody>
</table>

| Cross-sector as % of total | 16.7 |
| Bank-insurance as % of total | 0.6  |

#### Total M&As in financial services

<table>
<thead>
<tr>
<th></th>
<th>Total US acquirers</th>
<th>Total Europe acquirers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>507.1</td>
<td>305.6</td>
</tr>
<tr>
<td>Securities</td>
<td>11.7</td>
<td>83.4</td>
</tr>
<tr>
<td>Insurance</td>
<td>73.6</td>
<td>20.1</td>
</tr>
<tr>
<td>Total</td>
<td>592.4</td>
<td>187.7</td>
</tr>
</tbody>
</table>

| Cross-sector as % of total | 17.0 |
| Bank-insurance as % of total | 7.2  |
| Bank-bank as % of total | 49.0  |
| Insurance-insurance as % of total | 20.8 |

**Note:** The figures reported are the sum of equity values of the target institutions.

**Source:** Data kindly provided by Ingo Walter, Director of New York University Salomon Center, based on figures compiled by Thomson Financial Securities Data Company.
There are, however, important cross-country variations. In smaller European countries, such as the Benelux, conglomerates have become the dominant financial services providers, whereas in France and Germany, specialisation has prevailed. The latter was probably also due to limited foreign entry in both countries’ markets.

The strong contrast between the EU and the US financial systems may diminish in the years ahead. In the EU, the start of EMU signalled a shift towards more direct capital market financing, with a strong growth of the corporate and other non-government bond markets. The corporate bond market has grown by a factor of 2.5 in the first year of EMU. Several countries enacted legislation to allow a mortgage bond market to emerge. In the US, the segmentation of the financial sector may become definitively repealed. The Gramm-Leach-Bliley Act (1999) lifts restrictions on US-based financial institutions to work as financial conglomerates if they are licensed as a Financial Holding Company (FHC). Some 117 institutions have applied for FHC status in the US at the time of writing.

At product level, financial institutions have responded to growing competition through the introduction of new products and services and diversification of the product range. Combined bank-securities, bank-insurance, insurance-securities and even bank-securities-insurance products are offered on the market by a single firm. The sector-specific characteristics of such products are irrelevant for consumers; they only wish to see that the same level of consumer protection and similar conduct-of-business rules are applied to each product. This development has rendered the job of financial supervisors more difficult.

Although one could initially find no support in the economies of scope and scale literature for this process of financial sector consolidation, recent research has found a higher degree of cost efficiency in universal banks and conglomerates as compared to more specialised banks. Despecialisation may lead to more efficient financial systems (Vander Vennet, 1998). Also technological progress has affected efficient bank size, by allowing management to keep growing business under control. Recent research also showed that the overall cost savings of IT investments increased with the size of the bank (Molyneux, 1997). Others have demonstrated that the overall profitability of large banks is higher than that of small banks, with about twice as many small banks (weighted average) being non-profit-making as compared to large banks. This difference is even larger in the US (Inzerillo et al., 2000). Financial sector consolidation can thus be expected to continue.

Financial market liberalisation has hardened competitive conditions for European banking. On an aggregate basis, the performance of European banking did not change up to 1997 (the last year for which comparative figures are available), and it was low compared to that of US commercial banks. In certain countries, probably those that previously had the most protected markets, performance levels actually declined. Return on assets of all European banks, measured as profit before taxes as a percentage of total assets, stood at about 0.50% annually for the period 1995-97, as compared to 1.83% for the US commercial banks (OECD, 1999). Banks in some countries have consistently performed much better than the EU average, such as those based in the UK, but for others, such as French and Italian banks, the situation has been well below average, with a return on assets of 0.31% in 1997.

EMU should lead to a greater degree of financial market inter-penetration, which has been limited so far. The disappearance of the constraints of currency-matching rules and the prominence of European-wide bond and equity indexes should stimulate European banks and institutional investors to start to spread assets at a euro-wide level. Also cross-border banking penetration should grow. In 1997, the market share of foreign branches and subsidiaries exceeded 10% in only five EU countries: in declining order of proportion, if not absolute size, Luxembourg, Ireland, the UK, Belgium and Greece (ECB, 1999). By the end of December
1999, only 8.7% of the total loans of financial institutions in the eurozone were cross-border (ECB, 2000).

In sum, monetary union involves the continuation of a process of financial market liberalisation in Europe that is starting to acquire more European-wide dimensions. Three issues are important for supervisors in re-designing the supervisory framework at European level:

1. The Europeanisation of financial markets and the emergence of Europe as a whole as the home market;
2. The changes that EMU is bringing about in the largely bank-based European financial system; and
3. The trend towards conglomeration.

Europeanisation of financial markets may reduce the grip that supervisors have had in a national context on institutions under their supervision and may increase the possibility for regulatory arbitrage. While regulatory competition is in itself not a problem, as long as the minimum standards are sufficiently high, the question emerges whether the structure of supervisory cooperation is sufficiently developed to cope with stronger cross-border market integration, or whether supervisors will continue to seek to favour the national public interest.

The trend towards more market-based finance may ease the job of supervisors, since it should strengthen market discipline in European finance. Other elements of the regulatory set-up and the attitude of market actors will need to move in parallel, however, in order to increase the transparency of the financial system. This relates to accounting standards, reporting systems and corporate governance mechanisms.

The trend towards conglomeration is an additional challenge for supervisors. While conglomeration may increase cost efficiency and diversifies the risk for financial groups, the task of supervision does not become easier. With entities separately authorised and controlled, supervisory authorities risk being unaware of the overall risk profile of the group. The risks at group level are not necessarily the same as the sum of the risks of the different entities of the group: the group might have large exposures that are not readily apparent at the single entity level. Risks in the different parts of the business are simply aggregated and less transparent, which may also reduce market discipline. The danger of double-gearing of capital or uncontrolled intra-group transactions to cover losses in one entity with gains from another, also arises. Finally, a loss of confidence in one part of the group can affect the whole business, and thus increase volatility (Danthine et al., 1999). In the following section, we discuss how some countries have tackled this problem by adapting the institutional structure of financial supervision. We first look at the changes taking place at national level, and then move to the European dimension.

II. The structure of financial supervision

The single financial market programme was a process of financial re-regulation in the EU. National regulation was re-drafted on the basis of European benchmarks, set forward in directives. This did not, at least directly, affect the structure of financial supervision at local level. Nothing in EU financial services law currently prescribes how financial supervision should be organised. Member states are simply required to ensure that the sectors covered are adequately supervised and that basic minimum requirements (own funds, large exposures) are observed.

Traditionally, the structure of financial supervision was based on the functional divisions in the financial services sector and the perceived differences in risk profiles. Supervision in banking
has typically had a higher profile than that in insurance, because of the systemic element and hence the close involvement of the central bank. Securities market supervision was until recently largely based on sectoral self-regulation, but internationalisation of markets and European harmonisation of securities regulation have forced many member states to create securities supervisory bodies.

The move of monetary policy powers to the ECB has stimulated a debate in some countries whether banking supervision needs to remain under the same roof as the central bank, at least in the countries where this is still the case. The tendency towards conglomeration in the financial services industry is an argument in favour of a single supervisory authority, although conglomeration may also strengthen the arguments for more supervision by the functions of regulation. The pros and cons of these different constellations are analysed below.

**A. Central bank versus separate banking supervision**

Monetary policy and banking supervisory functions are separated in half of the EU countries and combined in the other half (see Table 2). Generally speaking, the arguments in favour of combining both functions revolve around the fact that it is the central bank’s role to ensure the stability of the financial system and prevent contagious systemic crises (Goodhart et al., 1997). The supervision and regulation of banking institutions contribute to better control of overall financial stability, regardless of who performs these functions. The issue is whether they can be done better in a central bank. Through its role as lender-of-last-resort (LOLR), the central bank should, it is argued, be involved in supervision as well. At the same time, however, the possibility that a conflict of interest may arise (even when a central bank only has one vote in overall euro monetary policy) argues against combining both functions. The central bank’s participation in bank rescues may endanger price stability and increase moral hazard. It may create competitive distortions if central bank money is allocated at preferential rates to a bank in trouble as compared to other banks. Finally, it may raise the expectation in the private sector that a central bank supervisor would be unduly influenced because of the reputational risk by considerations of financial system stability when determining monetary policy. This could seriously undermine the central bank’s credibility.

The fact that both regimes are equally represented in the EU suggests that there are no conclusive arguments for or against either model. According to Goodhart and Schoenmaker (1995), the question of the appropriate design has to be approached in the context of the particular financial or banking structure of each country rather than in the abstract. Their analysis of bank failures over the last two decades shows a much higher frequency of failures in countries with a separated regime than in those with a combined one. This does not, however, lead immediately to the conclusion that the latter regime is better. Many other factors come into play, such as the degree of financial deregulation, the quality of regulation, the willingness of the government to let a bank fail, or the existence of oligopolies in banking. Goodhart and Schoenmaker also found a stronger likelihood of commercial banks being involved in rescues in a combined regime, through the authority of the central bank, but they see this as a receding possibility.

| Table 2. Supervisors of banking, securities and insurance in Europe, Japan and the US |
|---------------------------------|-----|-----|-----|
|                                | Banking | Securities | Insurance |
| B                               | BS     | BS     | I     |
| DK                              | M      | M      | M     |
In recent years, the trend towards more integrated supervision has led to moving bank supervisory functions away from the central bank. The arguments for keeping banking supervision under the roof of the central bank have become less authoritative in comparison to the need to respond effectively to the increasing complexity of finance (see Briault, 1999). This was most clearly exemplified by the announcement in May 1997 of the proposed establishment in the UK of the Financial Services Authority (FSA), an integrated financial supervisor, involving the transfer of the banking supervisory function from the Bank of England. An additional reason for this development is the acceptance that only the government, and not the central bank, can take responsibility for ultimate financial support of banks in trouble. The ability of central banks to organise and coordinate bank rescues has been slipping, and bank rescues have become more expensive, going beyond the sums which the central bank can provide from its own resources. This was demonstrated earlier this decade in Finland, Norway and Sweden, but also more recently in Italy and France. There has consequently been no alternative but to rely on taxpayer funding, leading to more demand for political control of

Note: CB = Central Bank, BS = banking and securities supervisor, M = single financial supervisory authority, B = specialised banking supervisor, S = specialised securities supervisor, I = specialised insurance supervisor, SI = specialised securities and insurance supervisor, G= government department.

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1 The FSA has rule-making powers and is accountable to the government and Parliament. The Bank of England remains responsible for ensuring the overall stability of the financial system. The Bank would be the vehicle for lender-of-last-resort operations, if any, informing the Chancellor of the Exchequer, with the possibility then of an override by the Treasury. A Memorandum of Understanding between the Treasury, the Bank of England and the FSA sets out the respective responsibilities of the different bodies.
supervisory functions. Close cooperation between the supervisory and the monetary policy authorities remains crucial, however. Only the monetary policy authorities can provide immediate liquidity to the market in case of trouble. But price stability cannot be achieved if financial stability is not in place. This distinction is operational in the eurozone, where, under the Maastricht Treaty, the European System of Central Banks (ESCB) is responsible for monetary policy, and the national authorities for financial stability.

B. Integrated financial supervisor versus specialist supervisors

A second issue to be addressed is whether financial supervision should be assigned to one entity or whether it should be determined by the function of the business of the institutions under supervision or by the type of supervision (prudential or conduct of business). The conglomerate trend in the financial sector and the creation of the FSA in the UK has stimulated a discussion elsewhere in Europe on integrated financial supervisory authorities. An integrated authority is seen to generate economies of scale (and probably economies of scope) in supervision, as well as some practical and political advantages (see Table 3 below). It offers one-stop shopping for authorisations of conglomerate financial groups and eliminates any confusion over who exercises lead supervision and final control. Expertise is pooled and cooperation between the different functional supervisors is guaranteed. Unnecessary overlaps are avoided and support services such as personnel, administration and documentation can be merged. An integrated authority should thus over time lead to lower supervisory fees, at least in these countries where the financial sector contributes directly to the cost of supervision, and to a lower cost of supervision in general.

An integrated supervisor will however only be effective if it is more than a combination of divisions, and if synergies can be exploited. It has been argued that the crucial thing is not whether all the functional supervisors are under a single roof, but whether they communicate with one another. If an integrated supervisor is no more than a combination of banking, insurance and investment business divisions, the full benefits of a single regulatory authority will not be achieved.

A possible argument against an integrated supervisor is its potentially higher profile. It might be argued that the perception could somehow be created that the whole financial sector is secure, which may reduce the incentives for providers to prudently manage their business, and for users to carefully choose their financial services’ provider. It could also be argued that the failure of one institution could have more widespread effects in a combined regime because the supervisor was active in a number of different sectors. This risk has to be offset by educating users of financial services in the risks as well as the benefits of financial products.

The advantages of a specialist supervisor are a lower profile and a clearer focus on the sector under supervision. It could allow for a greater proximity to smaller firms on which a single regulator may be less inclined to focus, more specialisation and better awareness of the problems of the sector. Two arguments stand out: a growing need for specialisation in supervision and inter-agency competition. Very distinct skills are required from supervisors, ranging from monitoring potentially dangerous exposures in increasingly globalised financial markets and validating statistical models in a bank’s value-at-risk models to supervising complex financial groups or tracking market behaviour of investment funds, as well as a large degree of financial specialisation. It is an open question whether a single regulator can find it easier to recruit and retain specialists. It could be easier where there are specialisations such as market risk, credit risk and most forms of legal and operational risk, which apply across a range of different firms, and not just to firms in a particular sector (Briault, 1999).
The second argument, the advantage of inter-agency competition, is relevant, although perhaps difficult to advance in this context. Where several agencies work side by side, institutional competition can work and create incentives for each agency to work efficiently, while reducing capture (Fender and von Hagen, 1998). An example is the US structure of banking supervision, where banks can be chartered at either the state or national level. In the EU, regulatory competition between states forms an integral part of the single market programme. Many will argue, however, that inter-agency competition does not make sense. Competition between regulatory regimes runs the risk of reducing rather than improving quality, and it may better serve the interest of the supervised than that of the public.

Table 3. Comparative advantages of the dominant models in financial supervision

<table>
<thead>
<tr>
<th>Integrated financial supervisor</th>
<th>Specialist supervisor</th>
</tr>
</thead>
<tbody>
<tr>
<td>• One-stop shopping for authorisations</td>
<td>• Lower profile</td>
</tr>
<tr>
<td>• Pooling of expertise and economies of scale (certain units could be merged, e.g. authorisations, support services)</td>
<td>• Clearly defined mandate</td>
</tr>
<tr>
<td>• Lower supervisory fees</td>
<td>• Easier to manage</td>
</tr>
<tr>
<td>• Adapted to evolution in financial sector towards more complex financial products and financial conglomerates</td>
<td>• Better adapted to the differences in risk profiles and nature of the respective financial business (e.g. retail versus wholesale), clear focus on objectives and rationale of regulation</td>
</tr>
<tr>
<td>• Cooperation between types of financial business guaranteed; one lead supervisor or a single supervisory team for conglomerates</td>
<td>• Closer to the business (but not necessarily)</td>
</tr>
<tr>
<td>• Can reduce regulatory arbitrage and deliver regulatory neutrality</td>
<td>• Better knowledge of the business, more specialisation</td>
</tr>
<tr>
<td>• More transparent to consumers</td>
<td>• Stimulates inter-agency competition</td>
</tr>
<tr>
<td>• Single rulebook (a possibility)</td>
<td></td>
</tr>
</tbody>
</table>

An overview of financial sector supervision in the EU and the rest of Europe demonstrates that three EU countries (Denmark, Sweden and the UK) as well as Norway have a integrated financial services authority. In some of these countries (as also recently in Japan and South Korea), the integration of supervision resulted from serious trouble in their financial sectors or grave oversights in surveillance. In the other countries, a broad mixture of systems exists, ranging from separate supervisors with banking supervisors usually in association with the central bank and sometimes split between two agencies in the same supervisory discipline, to combined banking-and-securities or combined securities-and-insurance supervisors (see Table 2). In Austria, Belgium, Germany and Ireland, the creation of an integrated authority has been raised or is on the political agenda.

C. Supervision by objective

Another outcome of the conglomeratisation trend is that supervision will become more objective-driven, since the functional divisions of the business will be increasingly blurred. One possible model calls for one agency to carry out surveillance separately for systemic stability reasons, a second for prudential supervision and a third for conduct-of-business. Conduct-of-business supervision looks after transparency, disclosure, fair and honest practices, and equality of
market participants. The “stability” agency should concentrate on macro-prudential problems, which affect the conduct of monetary policy or overall financial stability, while the prudential agency controls the solvency and soundness of individual financial institutions and enforces depositor and investor protection.

Such a horizontal supervisory structure was instituted in Australia, further to the Wallis Committee of Inquiry in 1997. The Australian Prudential Regulatory Authority (APRA) supervises financial institutions on prudential grounds; the Reserve Bank of Australia looks after systemic stability and provides liquidity assistance; and the Australian Securities and Investment Commission (ASIC) controls market integrity and conduct-of-business rules.

APRA and ASIC report to the Treasury. Several EU countries have elements of an objective-driven system of supervision, mainly as far as the relationship between the banking and the securities supervisor is concerned. In Italy, for example, banks and securities houses are controlled by the Banca d’Italia on financial stability and prudential grounds and by CONSOB for conduct-of-business rules for the banking and securities industry. The UK had a broadly similar structure before all supervisory functions were merged in the FSA. However, one of the reasons for bringing together prudential and conduct of business supervision in the UK was the increasing overlap in their activities with the growing tendency of both types of supervisor to pay heightened attention in the same firms to senior management capabilities, high level systems and controls and other common issues (Briault, 1999).

A compromise solution was recently adopted by the Netherlands, which has the highest market share for financial conglomerates in the EU. To avoid institutional reorganisation and all the related political problems, but to allow for adaptation to market developments and a clear focus on the objectives of supervision, a Council of Financial Supervisors was established in August 1999. The Council is not a separate institution, but is an organ for regular consultation between the three sectoral supervisors (the banking supervisor in the central bank, and the separate insurance and securities supervisors) for cross-sectoral problems in prudential and non-securities related conduct-of-business control. The Dutch central bank remains solely in charge of systemic control, and the securities supervisor becomes responsible for all securities-related conduct-of-business control. According to the Ministry of Finance (1999) in the Netherlands, the Council will force supervisors to agree on effective control of cross-sectoral issues, but the final responsibility remains with the individual supervisors. It remains to be seen how effectively these arrangements work.

The Dutch experiment points to interesting routes for other countries and for the European structure. It may only be a partial solution towards a more streamlined structure of financial supervision in the longer run, but it could also indicate that the optimal solution needs to combine sectoral and cross-sectoral supervision. Three relevant implications for the European debate are the need for regular cross-sectoral consultation, the decision to leave the central bank in charge of systemic issues, while keeping securities market supervision separate.

III. The European angle

European financial market regulations allowed markets to integrate under the control of the home country. Home country supervisors are in charge of licensing branches across the EU and exercising consolidated supervision. To that end, a framework for regular exchange of information and cooperation at bilateral and European level is in place. A variety of committees have been established to carry out a variety of functions, ranging from advising the Commission on improvements to the legal and regulatory framework at European level, to exchanging views about supervisory policy and practice, and, in some cases, discussing specific cases. The host
country remains in charge of dealing with problems related to the stability of the financial system. With the start of EMU, macro-prudential oversight is coordinated by the ECB.

The developments outlined in Section I raise the question whether this framework is still appropriate. While it is not the role of the EC institutions to prescribe the supervisory structure at national level, adaptations may be required to face growing market interpenetration, conglomerate and Europeanisation of financial institutions.

**A. On the home country principle**

The principle of home country control was successful in opening up markets in the EU, at least in banking. The harmonisation of the essential elements of authorisation and supervision of banks in the Second Banking Coordination Directive (2BCD) allowed the single licence for cross-border provision of services and branching to work. Host country controls for prudential purposes were virtually abolished, administrative burdens reduced and capital requirements for branches (where they applied) eliminated. Moreover, the introduction of European legislation provided a major incentive for national legislators to streamline their applicable laws. Some problems remained relating to the application of the notification procedure for host country operations and the application of the general good clause. These were tentatively clarified in an interpretative Communication of the European Commission (1997a), which was not, however, wholeheartedly supported. Another issue, the liquidity control of branches by host country authorities for monetary policy reasons (Art. 14, 2BCD), has become irrelevant in EMU. The article is under review by the authorities.

The home country is in charge of exercising consolidated supervision of a bank throughout the EU. To avoid opaque structures, it is required that the home country is the place of the head office of the bank in the EU (in the so-called “post-BCCI directive”). From an international perspective, home country control is also the basic method for the supervision of cross-border banking in the Core Principles on Banking Supervision of the Basel Committee. The general intention is that the home supervisor has to act as the lead supervisor for branches, joint ventures and subsidiaries all over the world and needs to exercise consolidated supervision. Host country supervisors are expected to communicate all necessary information to the home country authorities.

In the area of investment services and retail insurance, the home country control principle has only been partially put into effect. The harmonisation in the investment services directive has gone less far than in banking, and more powers reside with the host country for the control of the respect of local conduct of business rules, which have not been harmonised, although they work on the basis of harmonised principles. The European Commission is committed to further harmonisation, as was indicated in the Financial Services Action Plan. In insurance, differences in contract law and taxation have limited the reach of the single licence for small risks, and thus of the home country control principle. For large risks, however, markets have become integrated.

Harmonisation of conduct-of-business rules in financial services has proven more challenging, because it revolves around differing views on what constitutes appropriate protection for consumers in historically very different marketplaces. It also tends to require more on-site examination, which is more demanding on a cross-border basis. It is notable that new EU legislation involving conduct of business regulation goes for maximum harmonisation, as seen for example most recently in the draft directive on distance-selling of financial services.

Two fundamental questions can be raised with regard to the working of the home country control principle: 1) How well has the principle functioned in an EU context so far? 2) Will it
continue to be relevant in a more integrated European financial market? The home country control principle is part of the limited harmonisation approach of the single market as set out in the Cassis de Dijon ruling (1978) of the European Court of Justice. Only essential requirements are harmonised to allow markets to integrate. Additional rules should adjust in a competitive process between jurisdictions. This raises the issue of regulatory competition, and the degree of competition that is permissible in an EU context.

The home country control principle was probably well adapted to an environment of limited competition. As long as cross-border business is limited, as was generally the case until the start of EMU (see Section I), regulatory competition probably had some effect in aligning the most striking differences between regimes, while the overall impact remains limited, because markets have not been very integrated. In a more integrated market, a process of further harmonisation can be expected as a result of pressures from the market and the authorities at national and European level. This will be required to reduce remaining powers of the host country in each of the disciplines (e.g. the notification procedure and the general good principle) or to expand harmonisation where it was limited (e.g. in banking, the deposit guarantee directive prohibited the “export” of higher levels of depositor protection in the EU).

The second question is whether the home country per se will continue to be relevant in an EU context. The big players in the European market will increasingly have a range of home markets, so could the EU as a whole become the home market? It has been suggested in the past (Gros, quoted in Schoenmaker, 1995) that the single financial market could follow the two-tier US system of state and federally chartered banks. Large European banks could then choose to be federally chartered and be allowed to regard Europe as a whole as their “home” country. This does, however, raise several fundamental problems:

1. Financial services legislation is not sufficiently harmonised today to allow this to happen.
2. It would require an EU Treaty change to create such a body (as would be required for a European SEC, single banking regulator or a euro-FSA.
3. Financial supervision implies accountability and tax powers for eventual bail-outs. While the former could perhaps be created to exist at European level, the latter would be much more difficult, and would entail explicit agreement between member states for burden-sharing of bail-outs.
4. There is no appropriate European framework of courts to impose sanctions for violations of law or to challenge the use made of powers.
5. Smaller banks (and member states) may see a dual framework as a competitive distortion.
6. There would be major company law ramifications to be considered.

B. European supervisory cooperation

Growing cross-border banking, home country control and the operation of host state regulation all raise the issue of bilateral and European cooperation between supervisory authorities. Memoranda of Understanding provide the underpinning for cooperation at the bilateral level. At European level, several committees are in place to ensure collaboration between supervisors.

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2 It has been suggested that the ECB might assume such a role but it should be noted that Art. 105.6 of the Treaty, which reads: “The Council may (...) confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings”, only refers to “specific tasks concerning policies”, not to day-to-day supervision, in which case a Treaty change would also be required.
1. Cooperation at bilateral level

A Memorandum of Understanding (MoU) is a form of agreement between supervisors, which has no legal force, but sets out the respective tasks and obligations of both parties. In principle, the EU directives make formal agreements between supervisory authorities of the member states superfluous, since they make cooperation a legal obligation. In practice, supervisors have continued to conclude MoUs to clarify what is involved in the supervision of financial institutions and markets, such as information exchange and mutual assistance, establishment procedures and on-site examinations. In banking, some 78 bilateral MoUs had been signed between EEA banking supervisors by the end of 1997 (Padoa-Schioppa, 1999), while there is a multilateral Protocol to the Insurance Directives which serves as an MoU and the EEA securities commissions have also signed a multilateral MoU in relation to exchange of information for market surveillance purposes.

Little more is available in the public domain about the scope of MoUs that have been negotiated on the supervision of banks. Perhaps this can be justified from a moral hazard and liability point of view, but it does raise the question whether the authorities should consider a higher degree of transparency. This could signal to the markets that supervisors have kept pace with growing market integration. More information is available on MoUs between securities commissions and regulated markets. In the latter case, the arguments against transparency do not apply, and regulatory tasks are often shared, and on a different basis across countries, between the securities commission and the stock exchange.

Cooperation through MoUs raises the question of effective coordination of supervision. Although not formalised, the supervisor who exercises consolidated supervision is generally seen as the coordinator. This does however raise a problem for the insurance sector, where consolidation is not commonly accepted as a principle. According to a recent report by the Economic and Financial Committee (European Commission, 2000b), there is a lack of clarity on the coordinated supervision of insurance groups. This applies even more for conglomerates with a predominantly insurance focus. It has been reported that some conglomerates recently restructured as principally insurance groups to escape consolidated supervision.

MoUs raise the question of supervisory methods and the content of information exchange. According to Mayes (1999), MoUs do not provide for regular transfer of routine information among supervisors, but only in the case where possible supervisory problems arise, including suspected misconduct. This is perhaps natural, but when information is transferred, the question arises what precise information is transferred and whether supervisory methods have been sufficiently harmonised for information transfer to be effective. Limited evidence suggests that much may remain to be done in this domain. According to Prati and Schinasi (1998), supervisory practices differ considerably in the EU. The Vice-Governor of the Austrian National Bank was recently quoted as saying that the differences in banking and supervisory systems in the EU are so big that they will only be overcome in the very long term, if at all.

As a way around this problem, it has been proposed that enhanced market disclosure about the bank’s capital structure and its risk profile would help in providing the necessary information to supervisors (Mayes, 1999). Since information exchange between supervisors may not be sufficiently developed in certain areas, strengthening market discipline would probably be a more efficient and faster way to facilitate the work of supervisors in a European context. This point is also stressed in the proposed “pillar three” of the Basel Capital Accord Review.

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3 “Die Unterschiede in den Banken- und Aufsichtssystemen sind so gross, dass sie sich, wenn überhaupt, nur auf sehr lange Sicht überwinden lassen”, Gertrude Tumpel-Gugerell, Vice-Governor of the National Bank of Austria at the Alpbach Forum, quoted in Handelsblatt, 3 September 1999.
2. **Cooperation at European level**

At European level, several committees exist to promote cooperation between supervisory authorities. Their principal tasks are to:

1. Provide a forum for the exchange of views and to act as a sounding board for the Commission on any proposals for supplements or amendments to legislation;
2. Discuss and adopt technical adaptations to the directives within the perimeters foreseen in the directives (the “comitology” procedure); and
3. Discuss and compare issues of supervisory technique and to facilitate the exchange of information and cooperation with respect to problems with individual institutions.

This is, however, a general characterisation, which varies between the sectors of financial services. The committees are most developed in banking. The highest number of committees exists for securities markets, but with the least powers. An umbrella, cross-discipline EU committee of financial supervisors does not exist.

In banking, three committees are in place (see listing in the annex). The Banking Advisory Committee (BAC) principally advises the European Commission with regard to policy issues in the formulation and implementation of EC legislation for the banking sector. It can also, if foreseen by the directives, agree on technical adaptations to the directives (the “comitology” procedure). In order to do this, it brings together senior supervisory and finance ministry officials. The Groupe de Contact, which consists only of banking supervisors of the European Economic Area (EEA), has dealt for nearly 30 years with issues of banking supervision policy and practice including the carrying out of comparative studies, arranging the exchange of information and handling cooperation with respect to issues arising from individual institutions.

The Banking Supervisory Committee of the ECB brings together the authorities responsible for monetary policy and payment systems oversight in the European System of Central Banks with EU banking supervisors to discuss macro-prudential matters and financial stability issues. It also assists the ECB in the preparation of the ECB’s advice on draft EU and national banking legislation (within euro area countries) as laid down in Art. 105(4) of the EU Treaty and Art. 25(1) of the ESCB/ECB Statute. Each of these three committees cooperates closely with one another, making papers available as appropriate.

In insurance, the BAC is broadly paralleled by the Insurance Committee and the Groupe de Contact by the Conference of Insurance Supervisors.

In the securities field, strictly speaking, there is no parallel structure to the legislative committees existing in the banking and insurance field. This means that any technical adaptation of the core directives (the investment services directive and the capital adequacy directive) needs to take the form of a formal amendment, with the problems and delays this can imply. This situation should now be remedied, following the agreement in the European Parliament on the structure of legislative committees. It should be noted, however, that a High Level Securities Supervisors Committee, which brings together representatives of member states’ securities supervisory authorities and finance ministries, has been in place since 1992. It assists the Commission on policy issues relating to securities markets and the development of the relevant European legislation. Two Contact Committees, one for the listing and prospectus rules and one for unit trusts (UCITS), exist to facilitate harmonised implementation of directives through regular consultations between the member states and to advise the Commission on any supplements or amendments. These committees have no “comitology” powers, which partially explains why they never acquired any particular influence.
The unresolved conflict between the European Commission, Council and Parliament on the implementing powers of a formal securities committee led in December 1997 to the creation of the Forum of European Securities Commissions (FESCO). FESCO brings together the statutory securities commissions of the European Economic Area (EEA). FESCO’s work concentrates on developing common regulatory standards and enhancing cooperation between members on enforcement and market surveillance issues.

C. The role of the ECB

According to the EU Treaty, the ECB is in charge of monetary policy and the smooth operation of payment systems, whereas financial supervision and stability remain the competence of the member states. This division of roles has been the subject of wide debate over the last months that focused principally on the potentially unrestrained lender-of-last-resort (LOLR) facilities of the separate national central banks in EMU, which may potentially conflict with the monetary policy role of the ECB. It has therefore been argued that the ECB should be giving an explicit LOLR function.

In essence, the reason for giving the ECB an explicit lender-of-last resort role is the possible conflict between the ECB’s responsibility for determining liquidity in the Eurosystem and the financial stability competences at local level. Local responsibility for LOLR operations can conflict with euro monetary policy and possibly stimulate excessive risk-taking. This was related to the fear, which has now receded, that the national central banks would dominate the Eurosystem, and that the ECB would not be sufficiently powerful to impose common rules. It has now been agreed that the ECB’s Governing Council should be consulted on LOLR operations that have EMU-wide implications\(^4\). This also implies, however, that the ECB will coordinate LOLR operations in relation to banks with widespread operations across Europe. As soon as a bank operates in more than two EU countries on a major scale, and is of systemic importance at European level, it is more likely that the ECB will take a leading role in rescue operations as primus inter pares and as a politically neutral body. The ECB’s Banking Supervisory Committee should be instrumental in ensuring regular consultation on these matters between national central bank officials and supervisors, and ensuring that the ECB is sufficiently informed.

Unlike the national central banks, however, the ECB has limited financial means and is not backed by a ministry of finance for an eventual bank rescue involving injections of capital. The ECB can only lend against good collateral. Even if the ECB assumes the coordinating role for the monetary policy aspects of LOLR operations relating to European financial groups, a solution will need to be found for this issue as well. A bail-out of such groups will only be possible under a burden-sharing arrangement between the different home countries. However, the risk is not imaginary that national ministries of finance and parliaments will be unwilling to pick up problems which have, in their eyes, originated in other parts of the EU (Goodhart, 1999).\(^5\) This discussion also raises problems related to European competition policy, as approaches to banks in trouble differ across countries and affect the level playing field. The latter issue is discussed in more detail below.

\(^4\) As stated by Tommaso Padoa-Schioppa, member of the ECB Executive Board, at the CFS Conference on “Systemic risk and lender of last resort facilities”, in Frankfurt, 11 June 1999. An agreement on this subject is said to have been reached in the ECB’s Governing Council at the end of July 1999.

\(^5\) Some Ministries of Finance are currently thought to be pushing for a debate on this subject, but others potentially involved are said to be unwilling to address such issues in the abstract.
The recent debate on the LOLR role of the ECB also revealed that the issue had been confused with a generalised liquidity problem in the Eurosystem. This is closely related to the monetary policy function of the central bank, on which there is no disagreement on the responsibility of the ECB to act. The ECB should be well informed about one of the reasons for such liquidity shortages, a gridlock in the payment system, through its task in promoting the smooth operation of payment systems. The ESCB’s large value payment system, TARGET, had a market share of 70% in large value payments in the first year of EMU.

Another element of the current consensus is the agreement that the procedure to confer specific tasks concerning policies relating to prudential supervision of banks and other financial institutions to the ECB, as foreseen under Art. 105.6 of the EU Treaty, should not be activated. It could give rise to conflicts of interest with the ECB’s monetary policy functions, which should at this stage be avoided. It would also require a complete redesign of the structure of financial supervision in the EU, which is based on the principle of member state home country control. The provision is currently seen as an ultimate fallback option, if the relationship between the ECB and the national supervisory authorities did not work or in case irresponsible behaviour by authorities at national level would have spillover effects in the whole eurozone.

D. How to respond to growing market integration

The deeper challenges in financial supervision are related to the characteristics of the European financial system and the increased competition and market integration that is stimulated by EMU. It will require agreement on the part of policy-makers and supervisors to act rapidly on the completion of the regulatory framework and the adaptation of the structure of financial supervision to market developments. Elements of the provisions worked out in the Netherlands provide at least some indication of the issues to be addressed at a European level – but because the tasks are different at a national and a European level, it is unlikely that any national structure will offer a model suitable at the European level. It comprises three elements: the surveillance of systemic issues, involving regulators, central banks and finance ministries; the need for closer cooperation between supervisors in a European board of financial supervisors to discuss cross-sectoral matters and to handle issues related to conglomerate groups; and the option to handle market supervision separately. If supervision is to remain at a national level, then a further levelling of the playing field for financial institutions in the EU also needs to be considered urgently.

1. Systemic issues

National central banks and supervisory authorities should step up their efforts to monitor market developments at European level and alert national and European authorities to exposures with a potentially systemic impact. Monetary union has connected 11 previously separate markets into a single currency zone. That this has effectively happened is clear from the interbank market, which has developed a deep euro-denominated money market. Banks have integrated their euro-denominated treasury operations and manage their euro-denominated collateral on a single basis. The parallel to this development is also that systemic effects will immediately have much wider dimensions, whereas previously they tended to be largely limited to within national boundaries. Interbank deposits represent about 19% of bank assets in euroland.

It is therefore essential that the eurozone is watched as one market. The ECB has its Banking Supervisory Committee, but the question has been raised whether this group will be sufficiently comprehensive in its approach to European financial markets, and whether the ECB will have sufficient access to research to effectively monitor markets. A case has therefore been made for a European Observatory of Systemic Risk (Aglietta and de Boissieu, 1998). The aim would be
to have one body in place to monitor market developments across Europe and alert national and European authorities to exposures with a potentially systemic impact. In practice, such an entity could most efficiently operate in a cooperative structure within the ESCB. Such work is already undertaken within the existing structure of the ECB’s Banking Supervision Committee. However, some think it could be useful to create a clearly distinct structure for this, and to signal this to the markets to provide reassurance that adequate account is being taken of the new environment created by the euro. Secondly, it will be important to take account of developments in securities markets and of non-bank intermediaries.

2. A future structure for European regulatory and supervisory cooperation

Three layers can be distinguished in the European structure of regulatory and supervisory cooperation, for each of which one coordinating body should be appointed:

1. **Coordination of regulatory policy.** The Financial Services Policy Group (FSPG), instituted in 1999, should continue to discuss priorities in financial regulation at European level. After the adoption of the Financial Services Action Plan, it was announced that the FSPG would continue “to provide strategic advice, to discuss cross-sectoral developments and to monitor progress under the Action Plan” (Ecofin Council, 25 May 1999). A higher profile and a clear hierarchy in the decision process may, however, be needed, and more transparency and openness in its deliberations.

2. **Coordination of supervisory matters.** No satisfactory, high-level structure is in place to deal with cross-sectoral supervisory issues at the moment. A European Forum of Financial Supervisors should therefore be urgently considered. This Forum should have two major tasks:

   - **Ensure effective supervisory coordination for large European financial conglomerates.** The Forum will have to monitor whether the different bilateral Memoranda of Understanding (MoUs), on a sectoral and cross-sectoral basis, provide a sufficient overall picture of the exposures of a group. A multi-sectoral MoU or protocol could be worked out for the exchange of information between supervisors on a cross-sectoral and cross-border basis to ensure that financial groups with operations in a range of different countries are properly supervised, with clear arrangements for the appointment of a lead supervisor.

   - **Coordination of supervisory practices.** The Forum should set as an objective to make consistent supervisory practices in the EU, whether through legislative or non-legislative means. The exchange of information on supervisory techniques should allow the Forum to make arrangements for the establishment of standards of best practice in financial supervision, which should over time lead to more convergence in supervisory practices in the EU and hence to a more efficient and integrated single market.

The Forum could be composed of the chairmen of the different sectoral supervisory committees, with the European Commission acting as secretariat. Individual supervisors would need to be invited on an ad-hoc basis.

3. **Coordination in financial stability matters.** Monitoring of financial stability should happen through the mechanism of something like the Observatory for Systemic Risk, discussed above. Effective emergency intervention should be coordinated by the an ad-hoc committee

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6 One function that could be performed by the Observatory is that it could act as a European risk-monitoring centre (see Meister, 2000).
of the Economic and Financial Committee (EFC), the body for regular consultation between the finance ministries, the ECB and the European Commission. Such an ad-hoc committee should be composed of the competent representatives of the member states’ finance ministries, central banks and supervisory authorities, with the Chairman of the European Forum of Financial Supervisors, a representative of the European Central Bank and the European Commission.

Expressed schematically, the structure might look as diagrammed below. Committees in between square brackets do not yet exist; committees in italics relate to proposals made in this report.

Table 4. The structure of European supervisory and regulatory cooperation

<table>
<thead>
<tr>
<th>Objective/sector</th>
<th>Banking</th>
<th>Insurance</th>
<th>Securities markets</th>
<th>Cross-sector and horizontal matters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory</td>
<td>Banking Advisory Committee (BAC)</td>
<td>Insurance Committee (IC)</td>
<td>[Securities Committee]</td>
<td>FSPG</td>
</tr>
<tr>
<td>Supervisory</td>
<td>Groupe de Contact</td>
<td>Conference of Insurance Supervisors</td>
<td>FESCO</td>
<td>[Forum of Financial Supervisors]</td>
</tr>
<tr>
<td>Financial stability</td>
<td>Banking Supervision Committee (ESCB plus EU non-central bank supervisors)</td>
<td></td>
<td></td>
<td>EFC</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>[Observatory for Systemic Risk]</td>
</tr>
</tbody>
</table>

The creation of a European Forum of Financial Supervisors could also be a useful way to stimulate cooperation where necessary between sectoral supervisors at the national level. Banking and insurance supervisors have gone their own ways in, for example, negotiating directives, and it is only with the growth of conglomerates that the resulting inconsistencies are beginning to be recognised and require resolution. Such a Forum would encourage them to agree on joint approaches to integrated groups or common views on cross-sectoral matters.

3. Supervision of securities markets

Securities market supervision involves both the supervision of markets and exchanges, narrowly defined, and of the firms that trade in them. It is essentially focused on devising, implementing and enforcing conduct-of-business rules: the control of integrity and transparency of markets, the behaviour of individual participants and the protection of investors. It is a different task from supervising the financial soundness of institutions, and it can be argued that the two tasks should be kept separate.

The development of a harmonised regulatory framework for EU securities markets and for investment business generally is less advanced than in the area of banking. Harmonisation has
not gone as far here and more reliance is placed on mutual recognition, as for example in conduct-of-business rules, which has hampered market integration. At member state level, the creation of separate supervisory authorities is of recent, and in some cases, very recent origin. Far-reaching differences remain in the institutional structure of supervision, the division between regulation and self-regulation, or between the powers of the national securities market regulator and the various market authorities.

The rapid integration of capital markets in EMU and the lack of a regulatory framework for the integration of stock markets in the EU have led some to argue for a European SEC to help overcome these barriers. Although it is not always clear just what the proponents mean, and whether they are focused simply on markets and exchanges or also on firms, we believe that it would at present be a step too far. Not only is there a prior need for more regulatory harmonisation, which the European Commission is committed to achieving, but also the arguments for a more integrated supervisory authority are less compelling for securities markets than for financial institutions. Risks related to inadequate respect of conduct-of-business rules are overall less disturbing than those related to insufficient institutional supervision. It follows that some degree of competition between systems may do little harm and could indeed be desirable. This is implicit in the principles governing the single market, as long as it does not hamper market integration. It also fits with the current structure of supervision of EU securities markets, where the dividing line between regulation and self-regulation differs significantly from country to country (Lannoo, 1999).

In order to achieve further harmonisation of securities market regulation, the next step should be an acceleration of the decision procedure towards the creation of an EU Securities Committee, to parallel the other two EC regulatory committees, to review not only to the ISD and CAD, but also the other securities directives. Moreover, clarity should be achieved to establish its relationship with the other existing securities committees that are in place, and a division of labour agreed with FESCO, the Forum of European Securities Commissions.

FESCO was created in December 1997, to enhance the exchange of information between the national securities commissions, to provide the broadest possible mutual assistance to strengthen market surveillance and effective enforcement against abuse, to ensure uniform implementation of EU directives and to develop common regulatory standards in areas that are not harmonised by European directives. Each FESCO member is committed to implementing these standards in its home jurisdiction. Despite its recent creation, FESCO has rapidly gained wide recognition and support for its work.

4. A further levelling of the playing field at EU level

A more integrated financial market will highlight the shortcomings in the EU regulatory framework. Three areas are at the core of the policy debate, and are closely related to the level playing field: 1) common approaches to banks in trouble; 2) the strict application of EU competition policy rules to state aids in banking; and 3) greater transparency in the rules applicable to banking mergers.

Several European banks have been bailed out over the last decade at great public expense. The governments in question were motivated by a variety of fears, including the belief that the bank was “too big to fail” and would cause too much economic damage to both depositors and borrowers, that a failure might be contagious and spread through interbank settlement systems (as in the so-called Herstatt risk), or lead to a general loss of confidence in the banking system and trigger damaging bank runs. As a result, a moral hazard problem remains.

Designing a safety net in the banking sector is a difficult exercise. The problem is how to respond to the phenomenon of systemic risk without creating adverse incentives for bank
managers. So far, governments have kept LOLR procedures deliberately vague. To reduce moral hazard, procedural and practical details of emergency actions are secret. The design of LOLR support in EMU is also seen as part of this “constructive ambiguity” (Prati and Schinasi, 1998). Others have argued that this approach should no longer be applicable. Maintaining a high degree of ambiguity may itself have led to excessive risk-taking by financial institutions and too much forbearance by the authorities in the face of banking problems. Such a policy can only be modified in a climate of greater transparency concerning the support that will be offered to banks in trouble, and under what circumstances (Enoch et al., 1997).

Within a European context, the choice of responses is limited, since several policies have been applied in the member states. Some states have selectively let certain banks fail, whereas others have used large amounts of taxpayers’ money to rescue a bank and/or gone to considerable efforts to arrange rescues through mergers. Such policies may have reduced market discipline in European banking and stimulated over-capacity. A more common policy for bank exit policies can thus only be implemented with clear indications from governments.

A combination of preventive (ex ante) and remedial (ex post) measures is needed. As part of the ex-ante policies, preventive corrective action (PCA) should be implemented across the EU. With PCA, supervisors undertake a gradualist response to banks in trouble. They typically set pre-specified minimum capital ratios, which initiate a progressive series of restrictions on the problem bank’s activities. This reduces the potential for regulators to apply forbearance and allow problems to become magnified, and reduces the danger that responses will be inconsistent with competitive neutrality (ESFRC, 1998).

The need for preventive corrective action is now formally proposed by the Basel Committee in its capital review, as part of the so-called “pillar two”, the supervisory review process. It sets out that early intervention by the authorities may be needed where a bank’s capital is falling relative to its risk. The focus of Basel is primarily on moral suasion to improve risk management and internal controls, whereas higher minimum capital ratios for supervisory intervention, so-called “trigger ratios”, are the exception: “In a few regimes, capital ratios represent triggers for supervisory action” (Basel consultative paper, 1999, p. 58). This position was supported in the recent Commission paper on the review of the regulatory capital requirements (European Commission, 1999b). The question could however be raised whether the Commission is not overemphasising the appropriateness of differences in supervisory approaches, now that they should converge more.7

As regards pillar three of the supervisory review, disclosure, it is unclear at this stage how far it should go. The Basel Committee came out in favour of extensive disclosure of actual regulatory capital ratios, the capital structure and risk exposure, without clarifying whether the capital requirement imposed by supervisors should be disclosed. The Commission, however, while generally being supportive of disclosure, affirmed that the capital requirement imposed by supervisors upon a bank (as distinct from its holding of regulatory capital) should not be made public. Publication of supervisors’ assessments could blunt the incentive for depositors and investors to make their own credit assessment, according to the European Commission, and changes in ratios could be incorrectly interpreted by analysts and/or lead to overreaction such as deposit runs. The latter could in its turn constrain action by supervisors (European Commission, 1999b, p. 79). It could on the other hand also be argued that non-disclosure may maintain the

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7 “Beyond basic enabling powers, each competent authority operates in a different legal, accounting and cultural context, and it is appropriate that supervisory approaches differ. The Instruments chosen to implement the new principles should allow supervisors to adopt different supervisory approaches,” European Commission (1999b, p. 70).
old thinking on constructive ambiguity, and perhaps not provide the right incentives to supervisors on how to deal with institutions in trouble.

Harmonised remedial policies are probably less of a policy priority at the moment. With PCA procedures in place, the likelihood of the supervisors actually needing to liquidate banks should be reduced. However, harmonised bank and insurance winding-up procedures have become more urgent given the increasing scale of cross-border business. Proposals were blocked for many years because of differences in views on the feasibility of a European approach to bankruptcy procedures. The Commission’s Financial Services Action Plan reiterated the need for urgent adoption of these measures, which seems now finally to have been given effect. Both measures were recently adopted by the EU Council.8

In the event that a bank is bailed out, the process is in principle subject to the EU rules on state aid, as set out in Art. 92 of the EU Treaty. These rules have been detailed, as far as their application to the banking sector is concerned, in the Crédit Lyonnais case.9 While acknowledging the special nature of the banking sector, the Commission says that Community law, especially the solvency ratio directive, has clearly set a criterion of “equal competitive conditions”. Thus, if state financial support is provided to banks, the Commission must establish whether the Treaty rules are being respected. Exceptions can be made, however, if a serious disturbance threatens the economy (Art. 92.3.b).

It has been argued that the banking sector should be exempted from the application of Art. 92 of the Treaty because of its special character and its role in financial stability (Grande, 1999). Banking supervisors should have independence in their assessment of the means of dealing with problem banks. Since banking supervision is kept at the local level in the EU, state aid should also be taken out of EU hands and decentralised. This would, however, open the door to dangerous precedents, and clear the way for all other forms of hidden state aids, such as state-guaranteed loans. It would also be inconsistent with giving the ECB some a priori involvement in LOLR procedures at local level, as discussed above. What could be argued for is some form of accelerated procedure for handling state aid issues in relation to state support for banks.

If state aid were somehow to be decentralised, there would also be no way to equalise competition in Community-wide bank take-overs. As indicated earlier, restructuring of financial markets in the EU has hitherto mainly taken place at national level, which has led to high levels of concentration in certain national markets. More European cross-border consolidation will increase competition and reduce the danger of oligopolies at national level. Emphasising the arguments for the special character of the banking sector would make it easier for local authorities to intervene in foreign hostile bank take-overs and further stimulate purely national consolidation. It should be clear that cross-border transactions involving the control of banks, or indeed other financial institutions, should not be prevented or burdened for reasons other than antitrust or safety and soundness concerns.

Take-over legislation, however, is not harmonised at EU level. Securities laws differ importantly from one country to another in the Community, with large differences in the rights attached to shares, in the powers of boards of directors and shareholders and in company law generally. Also the role of the supervisory authorities for take-overs differs importantly, or in some countries rules do not even yet exist (Lannoo, 1999). In the domain of banking, the national central bank, banking supervisor and ministry of finance are, to different degrees across

8 The EU Council reached a political agreement on the winding-up procedures for banks on 8 May 2000 and on those for insurance companies on 25 May.

countries, entitled to scrutinise bank take-overs, on the grounds that they are responsible for financial stability and prudential supervision. These authorities often have extensive discretionary powers, as was exemplified recently in France, Italy and Portugal. EU authorities should make sure that the general EU Treaty rules are respected, and the supervisory aspects of bank take-overs are based on the prudential rules of the EU’s second banking and solvency ratio directives, so as to ensure that eventual refusals have a clear basis. In the case of the Portuguese objections to the BSCH/Champalimaud merger, the European Commission referred the case to the European Court for non-compliance with the merger control regulation. This case was withdrawn in March 2000, after Portugal lifted its opposition to the concentration.

Some of the securities law aspects of take-overs are dealt with in the draft EU take-over bids directive, on which a common position was reached in June 2000. This directive may, however, not change so much, since many matters are left to the national implementing law. Moreover, the directive has 2004 as its implementation deadline.

A summary of the required changes in light of EMU and growing market integration is given in Table 5.

Table 5. Objectives of financial supervision and changes in the perspective of growing European market integration

<table>
<thead>
<tr>
<th>Objective of supervision</th>
<th>Current structure</th>
<th>Required changes</th>
</tr>
</thead>
</table>
| Systemic risk (financial stability) | National supervisory authorities and/or NCBs | Role for ESCB/ECB and national supervisors in monitoring systemic exposures in European financial markets  
Create European Observatory of Systemic Risk  
Give role to Economic and Financial Committee (EFC) to coordinate emergency intervention |
| Prudential control (solvency control/ protection of depositors/investors/policy-holders) | National supervisory authorities (home country)  
Bilateral Memoranda of Understanding  
Different attitudes to banks in trouble  
Excessive forbearance | Strengthen supervisory coordination through creation of Forum of Financial Supervisors  
Preventive corrective action policies EU-wide  
Harmonise supervisory practices  
Harmonise winding-up arrangements  
Align bank exit policies |
| Conduct of business (protection of consumers and investors) | Host country (country where service is provided) for retail and wholesale business  
No level playing field for | Home country rules for wholesale business  
Common interpretation of rules |
IV. Conclusions

Financial supervision in a European context needs to evolve progressively with growing market integration, but a more centralised approach in financial supervision can only be justified where national or local approaches are no longer adequate for performing the task. A coordinated approach is now necessary to handle systemic issues that will no longer be limited to national borders, but also, and increasingly, for monitoring financial institutions with operations in a range of European countries. There is a vital need to identify a lead supervisor for each financial group and to reach agreement on precisely what the responsibilities of a lead supervisor would be. On the other hand, the externalities are lower in the case of limited coordination of control of conduct-of-business rules in retail financial services or in dealing in securities markets.

In addressing the structure of financial supervision at European level, a more horizontal approach, based on the objectives of supervision, is required. It is adapted to the conglomeration trend in the financial sector and makes it easier to detect and handle lacunae in the present supervisory structure. For systemic issues, there is no suggestion of leaving the central banks solely in charge of these matters, but the role of the ESCB could still benefit from more public clarification, and some joint body with the supervisors created to monitor aggregate risks. In addition, central banks, supervisors and finance ministries will need to cooperate to draft principles governing bail-outs of European-wide groups, which currently implicitly fall to the country of control and consolidated supervision. Since the LOLR role presumes the back-up of a finance ministry, which may not be prepared to bail out creditors in other member states, burden-sharing between European countries is for the time being the only way forward.

On the supervisory side, more coordination is needed between the different sectoral supervisory committees at senior level. This is not in place for the time being, but is probably what is most needed in view of the continuing restructuring in European finance. A kind of European Forum of Financial Supervisors should therefore be urgently created. This forum should primarily discuss problems in the adequate supervision of large European financial groups, and if necessary, draft a multilateral and multi-sectoral MoU. Such a body should also set a work programme to align supervisory practices in the EU to ease pan-European operations.

What the institutional framework for financial supervision will look like in a decade is still an open question at this point. From what is already happening in the markets, a more uniform system of supervision will at some stage be required, and the strict sectoral division of financial supervision will be increasingly out of date. A reconfiguration of the structures of financial supervision, based on a clear setting out of the objectives of financial supervision, would be useful.

A further institutionalisation of supervisory functions at European level is, as circumstances currently stand, legally and practically impossible and in any case unlikely to be politically acceptable. Whether in due course there will be unified European institutions rather than networks of national authorities will depend a lot both on the ways in which markets develop and authorities react. Efficiency of operation will be a major issue, as will consistency with underlying national differences, not least in many detailed aspects of market structure. Whether EU and national authorities will see any merit in transcending their individual perspectives
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when reacting to developments set into motion by EMU and the internal market, and contemplate the establishment of transnational supervisors remains a very open question.
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ANNEX
EU AND EEA FORA FOR COOPERATION IN FINANCIAL SUPERVISION

Banking
1. Banking Advisory Committee (BAC)\textsuperscript{10}
   - Established in 1977 by the First Banking Coordination Directive.
   - Threefold role: 1) assists the European Commission in drawing up new proposals for banking legislation, 2) helps to ensure adequate implementation, and 3) serves as the “regulatory committee” under the so-called “comitology” procedures for technical amendments to EC banking legislation. The latter are changes that can be made outside the normal legislative procedure.
   - Consists of high-level officials from finance ministries, central banks and supervisory authorities of the member states and from the Commission, with a maximum of three representatives per national delegation; officials from other EEA countries and the ECB participate as observers; the chairman of the Groupe de Contact also attends.
   - Chairman is chosen for a three-year period from representatives of member states, secretarial services are provided by the European Commission.
   - Meets three to four times a year.
   - Discussions are confidential, but a tri-annual report is published by the chairman.
   - When committee acts as “regulatory committee”, it is chaired by the European Commission.
   - Does not consider specific problems related to individual credit institutions.

2. Groupe de Contact (established 1972)
   - Set up by banking supervisors of EEA member states on a cooperative basis.
   - Deals with micro-prudential cooperation, including information-sharing both in general and in particular cases, and carries out comparative studies on policies and techniques of supervision. It also assembles, as required under the banking directives, various EEA-wide statistical services including on solvency, profitability and liquidity.
   - Consists of one official from each banking supervisory authority in the EEA; an official from the Commission also attends as adviser on legal issues but does not attend discussions dealing either with individual firms or sensitive supervisory assessments.

3. Banking Supervision Committee of the ECB (established 1998)
   - Succeeded Subcommittee on Banking Supervision of the European Monetary Institute, which had originally been created in 1990 as the Banking Supervisory Subcommittee of the Committee of Governors of the EC Central Banks.
   - Assists the ESCB with regard to policy issues in the area of macro-prudential supervision, i.e. the stability of financial institutions and markets, and in preparing ECB opinions on legislation as provided for under the Treaty.

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\textsuperscript{10} This survey is largely based upon the Banking Advisory Committee’s most recent report of the chairman (1994-1997).
- Consists of high-level officials from all central banks and non-central bank supervisory authorities in member states plus ECB officials; Commission officials participate as observers.

Duplication of work is avoided through regular informal coordination meetings between chairmen of each of the three committees dealing with banking supervisory matters.

**Securities markets**

4. **Contact Committee (established 1979).**
   - Advisory committee, without comitology role (except for one issue, which was never touched).
   - Allows regular consultation between the member states on these matters.

5. **UCITS Contact Committee (established 1985)**
   - Advisory committee, without comitology role.
   - Facilitates harmonised implementation and advises the Commission on any amendments to the 1985 UCITS directive (unit trusts directive).

6. **High-Level Committee of Securities Market Supervisors (established 1985)**
   - Strategic committee, meets 2 to 3 times a year at the initiative of the European Commission.
   - No formal legal basis, functions as Commission working group until Securities Committee is formally established by an EU directive.
   - Advises the European Commission on regulatory and supervisory matters.

7. **FESCO (Forum of European Securities Commissions, established December 1997)**
   - Originates from Informal Group of Chairmen of EU Securities Commissions.
   - Brings together securities commissions of the European Economic Area (the EU, Iceland and Norway).
   - Aims to enhance the exchange of information between national securities commissions, to provide the broadest possible mutual assistance to enhance market surveillance and effective enforcement, to enhance uniform implementation of EU directives and to develop common regulatory standards in areas that are not harmonised by European directives.

8. **Securities Committee (proposed)**
   - High-level committee with implementing powers for the investment services and capital adequacy directives.
   - Rejected twice because of procedural problems and sensitivity of European Parliament to “comitology”.
• Relaunched in the Commission’s financial services action plan (May 1999), to be proposed at the end of 2000.

Insurance

9. Insurance Committee (established 1992)
   • Assists the European Commission with regard to policy issues in the formulation and implementation of EC legislation for the insurance sector, consultative role for new Commission proposals.
   • Consists of high-level officials from finance ministries and supervisory authorities of the member states plus Commission officials; officials from other EEA countries participate as observers.
   • Serves as “regulatory committee” under the so-called “comitology” procedures for technical amendments to EC insurance legislation (life and non-life insurance).
   • Does not consider specific problems related to individual insurance undertakings

10. Conference of Insurance Supervisory Authorities of the EU (established 1958)
   • Forum for debate among EU supervisors on micro-prudential issues relating to individual insurance undertakings.
   • Agreed on ‘protocols’, a form of multilateral memorandum of understanding between insurance supervisors, to deal with supervisory problems.
   • Composed of 15 EU states and 3 EEA countries, with European Commission as observer (no formal link with EU).
   • Meets twice a year

Cross-sector fora

   • Established in 1999, involving representatives of the sectoral regulatory committees.
   • Considers information sharing between supervisors and co-ordination of prudential supervision on a cross-sectoral and cross-border basis, capital adequacy at group level and intra-group transactions.