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# **SUPERVISING THE EUROPEAN FINANCIAL SYSTEM**

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# **SUPERVISING THE EUROPEAN FINANCIAL SYSTEM**

## ***CEPS POLICY BRIEF No. 21***

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The EU's financial sector has been undergoing an almost continuous wave of de- or re-regulation since the late 1980s. The Single Market programme with minimal harmonisation and home country control was implemented in successive periods for banking, insurance and the securities markets. By the end of the 1990s, however, under the impact of EMU, it was clear that this was not sufficient, and a Financial Services Action Programme set a schedule for the adoption of 42 directives to create a truly integrated financial market by 2005. Moreover, a Committee of Wise Men under the chairmanship of Alexandre Lamfalussy made proposals to ease the adaptation of EU financial regulations to market developments.

In the meantime, a re-design of the structure for financial supervision has been progressing. Traditionally designed along the different segments of the financial sector, a clear trend towards integration has emerged. At the national level, the creation of the Financial Services Authority (FSA) in the UK was a clear signpost, which has been followed in the meantime in several other countries. At the European level, a debate started with the creation of the European Central Bank (ECB), which has no powers in the area of financial supervision. This has given rise to the question of whether home country control can continue to coincide with growing financial market integration, or whether a different structure will be needed at the European level.

The debate has recently become more complex. While initiatives have been taken to strengthen cooperation between supervisors at the European level, both within and across sectors, it has become clear that a solution for the European context will need to be specific and tailor-made. This is the case, not only because of sensitivities within the member states towards too much centralisation, but also because supervision so far has been organised in different ways by the various member states. The interests of the different parties

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\* The author is Chief Executive at CEPS. This paper was prepared for the European Roundtable of Financial Services (ERF). It is based upon earlier work carried out in the context of a CEPS working party on "Challenges to the structure of financial supervision in the EU", (July 2000).

involved have to be accommodated. Moreover, Europe's financial markets remain fragmented and are at different stages of development.

The main actors in the debate are the national supervisory authorities, the European Central Bank and the European Commission, the financial institutions and the securities markets. The issues at stake are the respective roles to be played by the national central banks and the ECB in financial supervision, integrated versus specialised financial supervision, the continuing relevance of the home country control principle and the adequacy of supervisory cooperation.

The purpose of this paper is to address the problems connected to reforming the structure of financial supervision in the EU. Furthermore, it discusses the challenges as perceived from the point of view of supervisors as well as those being supervised. After reviewing the current models and structure of financial supervision and the form of European regulatory and supervisory cooperation, we address the shortcomings in view of the continuing market integration and identify possible remedies.

## **I. Financial Supervision: Current models and structure**

Traditionally, the structure of financial supervision was based on the functional divisions in the financial services sector. Generally speaking, banks, insurance companies and securities markets had their own distinct supervisory authorities, operating with varying degrees of autonomy vis-à-vis the central government (see Table 1). The most homogeneously organised is the insurance sector, which functions as a separate independent authority in most member states. The most heterogeneous form is found in the securities markets, where the powers are spread over single supervisory structures, combined with banking supervision or separately organised. Moreover, aspects of securities markets supervision are often spread over different authorities, with important self-regulatory powers left to the stock exchange.<sup>1</sup> Banking supervision was until the early 90s largely in the hands of the national central bank, or executed in close cooperation with it.

In the meantime, the main change has been the gradual erosion of the central banks' involvement in banking supervision. The predominant view is that central banking is about maintaining price stability, as was also laid down in the Maastricht Treaty, and that their involvement in banking supervision may pose a conflict of interest with the price stability mandate. Finance has also become increasingly complex, with the traditional sectoral borders of the industry

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<sup>1</sup> The control of brokers and investment funds, securities settlement systems, listing procedures and securities markets may, in the extreme case, be spread over different authorities, as was until very recently the case in Germany. For an overview see Lannoo (2001), p. 44.

becoming blurred, leading to the view that integrated financial services authorities may be more appropriate for the job. In these circumstances, the exercise of banking supervision under the same roof as the central bank was seen as a barrier towards a more overall integrated supervision of the financial sector as a whole.

*Table 1. Supervisors of banking, securities and insurance in Europe, Japan and the US (early 2002)*

	Banking	Securities Markets	Insurance
B	BS	BS	I
DK	FSA	FSA	FSA
DE	FSA	FSA	FSA
EL	CB	S	I
E	CB	S	I
F	B/CB	S	I
I	CB	S	I
IRL	CB	CB	G
L	BS	BS	I
NL	CB	S	I
AU	FSA	FSA	FSA
P	CB	S	I
SF	BS	BS	I
SW	FSA	FSA	FSA
UK	FSA	FSA	FSA
CH	BS	BS	I
CZ	CB	SI	SI
H	FSA	FSA	FSA
N	FSA	FSA	FSA
PL	CB	S	I
SLOE	CB	S	G
USA	B/CB	S	I
J	FSA	FSA	FSA

*Notes:* CB = Central Bank, BS = banking and securities supervisor, FSA = 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. The supervision of securities markets is a generalisation of the most prevalent model in a certain state; it does not take the spread of the elements of supervision over different authorities into account.

The first integrated financial supervisory authorities in Europe were created at the end of the 1980s in the Nordic countries. Norway integrated bank and insurance supervision in 1986, followed by Denmark in 1988 and Sweden in 1992. The most exemplified, however, was the creation of the UK Financial Services Authority (FSA) in May 1997, which regrouped seven different financial sector supervisory authorities.<sup>2</sup> The German FSA, the Federal Agency for Financial Market Supervision, was proposed in January 2001 and formally started in May 2002, although some important exceptions remain, such as leaving the supervision of securities markets in the hands of the Länder. The German structure will continue to be decentralised for some time to come, which raises questions about its operational effectiveness. The FSA in Austria started to function in April 2002. In Belgium and Ireland, financial supervision will be integrated under the aegis of the central bank.<sup>3</sup>

The advantages of an integrated financial supervisory authority, as compared to specialist supervisors, are not clear-cut. Although it may seem obvious that an integrated authority is the most suitable for responding to the evolution in the financial sector, the first set of questions that needs to be answered is: What is financial supervision about, and what structure fits best to meet these objectives?

Financial supervision is about protecting consumers and ensuring the stability of the financial system. At first sight, it does not seem too make much difference whether this is done by an integrated or a specialist supervisory authority. It would be a matter of balancing the advantages of the different models in view of the policy priorities. A specialist authority can be better aware of, and more specialised in, the sector and products it supervises. On the other hand, an integrated supervisory authority may provide for more streamlined supervision and better oversight of integrated financial groups. A schematic comparison of the main advantages of both models is given in Table 2.

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<sup>2</sup> 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.

<sup>3</sup> In Ireland, notwithstanding earlier proposals to create a fully independent FSA, the central bank has been largely successful in retaining powers over financial supervision. The central bank will be renamed “Central Bank and Financial Services Regulatory Authority of Ireland”, and the FSRA will be established as “a constituent part of the Bank”, albeit with its own Board of Directors, which will be appointed by the Ministry of Finance. The proposals should be enacted by the middle of 2002. A similar model was enacted in Belgium.

*Table 2. Comparative advantages of the dominant models in financial supervision*

<b>Integrated financial supervisor</b>	<b>Specialist supervisor</b>
<ul style="list-style-type: none"> <li>• One-stop shopping for authorisations, and (possibly) a single rule book</li> <li>• Adapted to evolution in financial sector towards more complex financial products and financial conglomerates</li> <li>• Eases cooperation between sectoral supervisors; one lead supervisor or a single supervisory team for conglomerates</li> <li>• Can reduce regulatory arbitrage and deliver regulatory neutrality</li> <li>• Pooling of expertise and economies of scale (certain units could be merged, e.g. authorisations, support services)</li> <li>• Lower supervisory fees</li> <li>• More transparent to consumers</li> </ul>	<ul style="list-style-type: none"> <li>• Lower profile</li> <li>• Clearly defined mandate</li> <li>• Easier to manage</li> <li>• Better adapted to the differences in risk profiles and nature of the respective financial businesses (e.g. retail versus wholesale), clear focus on objectives and rationale of regulation</li> <li>• Closer to the business (but not necessarily)</li> <li>• Better knowledge of the business, more specialisation</li> <li>• Stimulates inter-agency competition</li> </ul>

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. It offers one-stop shopping for authorisations of conglomerate financial groups and eliminates any confusion as to the responsible party for leading supervision and executing 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 lead to lower supervisory fees, at least in those 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 execute effective supervision if it is more than a combination of divisions, and if synergies can be exploited. It has been argued that the crucial factor is not whether all the functional supervisors

are under a single roof, but whether they communicate with each another. This is certainly not a simple task, if one considers that the British FSA employs about 2,000 persons. 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.

Financial supervision is also about not giving the wrong signals. In this sense an important argument against an integrated supervisor is its higher profile. A Leviathan supervisor could create the perception that the whole financial sector is secure. It may reduce the incentives for providers to prudently manage their businesses, and for users to carefully choose their financial services' provider, the so-called "moral hazard" problem. It could also be argued that the failure of one institution would have more widespread effects in a combined regime, because the effectiveness of supervision of the whole financial sector would be called into question.

The advantages of a specialist supervisor are its lower profile and a clearer focus on the sector, and/or objective of supervision. It can 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 are prominent. Firstly, 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, validating statistical models in a bank's internal ratings, to supervising complex financial groups, or tracking market behaviour of investment funds. It is an open question whether a single regulator can do this better than specialist supervisors.

The second argument, the advantage of inter-agency competition, is relevant, although it may, at first sight, seem difficult to advance in this context. Where several agencies work in parallel, institutional competition can create incentives for each agency to work efficiently and concentrate, while reducing capture. An example is the US structure of banking supervision, where banks can be chartered at either state or national level. In the EU context, regulatory competition between states forms an integral part of the single market programme. Financial supervision is also part of this, and member states and financial centres are competing with different regulatory and supervisory models to attract business. This consideration has also played a role in the creation of the FSA in the UK.

One outcome of the conglomeration trend, and of the undecided debate of single versus specialised supervisors, is that supervision may become more objective-driven. Since the functional divisions of the business will be increasingly

difficult to make, authorities will look for other ways to supervise the financial sector efficiently. One possible model calls for one agency to carry out surveillance separately for systemic stability reasons, a second for prudential motives, 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. And the prudential agency would control the solvency and soundness of individual financial institutions, and enforce depositor and investor protection.

Such a horizontal supervisory structure was instituted in Australia, following 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, if needed. The Australian Securities and Investment Commission (ASIC) controls market integrity and conduct-of-business rules. Several EU countries have elements of an objective-driven system of supervision, mainly where 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 reasons. A similar model is to be introduced in the Netherlands in the course of 2002, where conduct of business supervision for the whole financial sector will come under a newly created Authority for Financial Markets. At the prudential level the central bank and the insurance supervisor will integrate supervision for cross-sector activities (see Jonk et al., 2001).

An objective-driven approach points to interesting routes for adaptation of the European structure of supervision. Rather than emulating one or another sectoral model at European level, an objective-driven approach may be better adapted to the economic and political circumstances of European integration. But, first we will discuss the current structure of European supervisory cooperation.

## **II. European regulatory and supervisory cooperation**

European regulatory and supervisory cooperation is more elaborate than one might initially think. All EU single passport directives for the financial sector also provide for a structure of cooperation between national *regulators*. Moreover, a structure is also in place to discuss cross-border *supervisory* issues. Two questions need to be addressed in view of growing financial market integration: i) the appropriateness of the home country control principle, and ii)

the relevance of the current structure of European regulatory and supervisory cooperation.

#### ***A. The home country control principle***

The home country control principle is part of the minimal harmonisation approach of the Single Market, whereby only essential elements are harmonised to allow markets to integrate. Additional rules should under mutual recognition be adjusted in a competitive process between jurisdictions. This raises the issue of regulatory competition, and the degree of competition that is permissible in a EU context.

So far the home country control principle has functioned fairly well. In response to growing market integration, a process of further harmonisation can be expected, as a result of pressures from the market and authorities at national and European levels. This will be required to reduce the remaining powers of the host country in each of the sectors (e.g. the notification procedure and the general good principle in all the single licence directives, liquidity control of branches in the 2<sup>nd</sup> banking directive, etc.) or to expand harmonisation where it was insufficient (securities markets). Some of these issues have already been addressed in the European Commission's Financial Services Action Plan.

But will the home country remain relevant in a EU context? Since major players in the European market will increasingly have a range of home markets, can the EU as a whole become the home market? Some large financial groups have thus argued for a single European regulator for some time. As seen by one of the most important proponents, "there is a marked trend towards a single European regulator. Following EMU and the single financial market, the decentralised regulatory model, although by all means successful in the past, is now weakening the efficiency of supervision and placing its competitive neutrality at risk. A united European approach would also carry greater weight in international negotiations on regulatory issues" (Deutsche Bank, 2000). Others have suggested that the single financial market could follow the two-tier US system of state and federally chartered banks. Large European banks could thus choose to be federally chartered and be allowed to regard Europe as a whole as their "home" country (Schoenmaker, 1995).

The discussion above about single versus specialised financial authorities has indicated that the answer is not so easy. From a supervisory perspective, however, a European FSA would exacerbate the disadvantages of a single regulator at national level, as discussed above. From a regulatory point of view, it would be difficult to reconcile with the basic principles of the Single Market, whereby only essential rules are harmonised and the rest is left to adjust via a competitive process between jurisdictions. In this sense, it is certainly not

proven that a single authority would improve supervisory efficiency, as it would eliminate this competitive process. Besides, a single EU supervisor would lead to important legal problems for areas that have not been fully harmonised at the EU level. Would a European supervised group fall under the single regulator for some aspects of its business, whereas others would fall under national law?

Also politically it would be difficult to argue for a single supervisory authority, as it would have to be proven that financial supervision could be better executed at the federal than at the national level, thus leading to a Treaty change to create such a body.<sup>4</sup> Moreover, financial supervision implies accountability and tax powers for eventual bail-outs. While the former could be dealt with, the latter would be much more difficult and would entail explicit agreements between member states for burden-sharing or bail-outs. Finally, smaller banks (and member states) may see a single regulator, and even more a dual framework, as a competitive distortion.

### ***B. European supervisory cooperation***

If home country control is to remain the basis of financial supervision in the EU, supervisors will need to ensure that bilateral and European cooperation works. Memoranda of Understanding provide the underpinning for supervisory cooperation at bilateral level. At European level, several committees are in place to ensure coordination between regulators and supervisors.

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 90 bilateral MoUs had been signed between EEA banking supervisors by the end of 1999. Furthermore, there is a multilateral Protocol to the Insurance Directives, which serves as an MoU. The securities commissions of the EEA

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<sup>4</sup> As would be required for a European Securities and Exchange Commission (SEC), a single banking regulator or a European FSA. It has been suggested that the ECB might assume the role of a single banking regulator without a Treaty change, but it should be noted that Art. 105.6 of the EU Treaty 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”. It only refers to “specific tasks concerning policies”, not to day-to-day supervision, in which case a Treaty change would also be required.

have, in the context of FESCO, also signed a multilateral MoU on exchange of information for market surveillance purposes.

MoUs raise the question of supervisory methods and the content of information exchange. If the information that is demanded from financial institutions differs from one member state to another, the information exchange will be of little use. This will be even more so if it concerns a financial institution that is active in several member states. From the perspective of a financial institution it will not be very attractive either, as they will need to report in different ways in the EU. The European Commission and national authorities have recently stepped up their activity in this area. A study is expected to be published soon by the European Commission on this subject as a first step towards more harmonisation of supervisory practices.

Information exchange is even more important during crisis situations. However, EU directives do not impose an obligation for information-sharing in times of crisis. A recent report from the EU's Economic and Financial Committee (2001), thus recommended that MoUs should be further developed to make them more specific with respect to crisis management. It was suggested that this could best be done by the several committees that exist at European level.

Several committees have been in place at a EU level to promote cooperation between regulatory and supervisory authorities. Most of them were created with the start of European legislation in the area. 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 different sectors of financial services. The committees are most developed in banking. The highest number of committees exists for the securities markets, but with the least powers, at least until the Lamfalussy report was adopted. A schematic overview is given in Table 3, where we distinguish between committees dealing with regulatory, supervisory and financial stability matters. This distinction is to a certain extent arbitrary, since the tasks of the different committees are often not as clear-cut.

*Table 3. The current structure of European supervisory and regulatory cooperation*

Objective/ sector	Banking	Insurance	Securities markets	Cross-sector and horizontal matters
Regulatory	Banking Advisory Committee (BAC)	Insurance Committee (IC)	Securities Committee	Financial Services Policy Group (FSPG) Mixed Technical Group on Financial Conglomerates
Supervisory	Groupe de Contact	Conference of Insurance Supervisors	Committee of European Securities Regulators (CESR, formerly FESCO)	Cross-Sectoral Roundtable of Regulators
Financial stability	ECB's Banking Supervision Committee (ESCB plus EU non-central bank supervisors)			Economic and Financial Committee (EFC) ECB's BSC

In banking three committees are in place. 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. In addition, according to the directives, it can agree on technical adaptations to the directives. In order to do this, it brings together senior supervisory and finance ministry officials. The **Groupe de Contact**, which consists only of banking supervisors from the European Economic Area (EEA), has dealt for nearly 30 years with issues of bank supervisory 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 Supervision Committee** of the **ECB** brings together the banking supervisors to discuss macro-prudential and financial stability issues of all the EU countries, and thus not only the eurozone. It also assists 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.

In response to criticism on the lack of macro-prudential oversight in the EU, the ECB has recently explicitly indicated that its Banking Supervision Committee will also perform that role (Meister, 2000; EFC, 2001, p. 7). During the Russian crisis in 1998, it appeared that European banks had large exposures to emerging markets, but no one was monitoring this from a European perspective. Such a situation could be systemic at eurozone level, as a financial crisis would rapidly spill over from one market to another via the inter-bank market. The creation of a European Observatory of Systemic Risk was therefore proposed (ESFRC, 1998).

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, there was, strictly speaking, until recently no parallel structure to the legislative committees existing in the banking and insurance field. There were some committees, but they had only a consultative function, and lacked seniority. A first reaction was the creation of FESCO in 1997, but this occurred outside the EU framework as an intergovernmental consultative body. The Lamfalussy Committee (February 2001) discussed this situation at length, in the context of the need to adapt legislation rapidly to changing market circumstances. It proposed a four-level approach as a model for securities market legislation – which could also be applied to financial services legislation in general – consisting of:

1. Framework legislation, which may be directives or regulations under EU law, and is limited to setting the general principles of legislation;
2. A new EU Securities Committee, with broad implementing powers, i.e. large interpretative powers for those elements of the directives or regulations where it has a mandate;
3. Strengthened cooperation between national regulators in the Committee of European Securities Regulators (CESR). This Committee replaced the FESCO (Forum of European Securities Commissions) structure, and gave it a formal mandate in the EU context; and
4. Stricter enforcement through more cooperation between national regulators and higher use of infringement procedures by the European Commission.

The Charter of the **Committee of European Securities Regulators (CESR)** was formally adopted on 11 September 2001. It states that CESR will improve coordination among European securities regulators and advise the European Securities Committee on implementing measures, while remaining independent from the European Commission. The creation of the **European Securities Committee**, on the other hand, gave rise to lengthy discussions with the European Parliament (EP) on the degree of implementing powers of an

unaccountable Committee. The EP requested a call-back on decisions taken by the Securities Committee, which the European Commission was unwilling to give for constitutional reasons. The EP finally agreed with the Securities Committee on 5 February 2002 (almost one year after the adoption of the Lamfalussy report) on the condition that it would be fully informed about the decisions taken by the Committee and that it would have sufficient time to make its wishes heard. The European Parliament's agreement also depends on a satisfactory solution being found to the "comitology" issue in the context of the 2004 Intergovernmental Conference.

From a sectoral perspective, the framework for regulatory and supervisory cooperation in the financial services sector could be considered as complete since the adoption of the Lamfalussy report. The structure has also become more complete concerning cross-sectoral matters. In 1999, a **Mixed Technical Group on Financial Conglomerates** was created to discuss cross-sectoral regulatory matters. In response to the recommendations of the Brouwer report (European Commission, 2000), a **Cross-Sectoral Roundtable of Regulators** was set up to promote exchange of information among supervisors. For conglomerates specifically, a new draft directive on financial conglomerates (April 2001) provides for mandatory appointment of one or more supervisory coordinators for any conglomerate that falls within the scope of the directive. The draft directive lays down the specific tasks of the coordinator of each financial conglomerate, such as the assessment of the financial situation of the group, its structure, organisation and internal control systems (Art. 7).<sup>5</sup>

Regulators have also taken initiatives to cover specific areas in the financial sector. In April 2001, the ECB announced the conclusion of a MoU between payment systems overseers and banking supervisors in the eurozone, because of the financial stability dimension (ECB, 2001c). In October, the ECB also announced joint work with CESR on issues of common interest in the field of securities clearing and settlement systems, with the intention of establishing common standards. In a statement on the consolidation of central counter-party clearing (September 2001), the ECB insisted on the role of the Eurosystem in setting risk management standards of such systems, because of the systemic dimension. The ECB also indicated that, for the same reasons, any "domestic" market infrastructure for securities and derivatives denominated in euro should be located in the euro area.

This overview would be incomplete without a brief mention of the **Financial Services Policy Group** (FSPG) and the **Economic and Financial Committee**

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<sup>5</sup> Proposal for a directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM(2001)213 of 24.4.01.

(EFC), although they are strictly speaking not part of the fora for financial supervision. The FSPG was set up by European Commissioner Mario Monti in 1998 as part of the effort to re-launch the internal market for financial services in the FSAP. Its main purpose is to set the strategic directions for EU financial services regulation. It brings together finance ministry officials and other high-level civil servants. The EFC has discussed general macro-prudential and specific financial market issues in ad-hoc committees, and has made policy recommendations. There is thus clearly no lack of multilateral fora for regular consultation among the respective authorities of the EU member states.

### **III. Challenges to adequate financial regulation and supervision**

Most of the challenges concerning adequate regulation and supervision in the EU have been on the policy agenda since the start of EMU, or even earlier. They have not become less pressing in the meantime. It concerns better enforcement of rules, the need to open-up retail financial markets and the problem of crisis management in the EU. Some new issues have emerged. These relate to the functioning of the new “post-Lamfalussy” committee structure, the implementation of Basel II and the adequate regulation of securities markets.

#### ***A. Better enforcement of rules***

Enforcement of EU regulation has for a long time been known to be a problem but was brought even more to the foreground by the Lamfalussy report. The latter recommended a fairly complex structure to improve enforcement of rules in securities markets, a structure that could also be transposed to the other sectors. It consists of the need to split legislation into framework principles and implementing measures, broader powers for a Committee to interpret and adapt legislation, the strengthening of cooperation between national regulatory authorities, and greater reliance upon judicial procedures.

Although the proposals in the Lamfalussy report are welcomed, the experience acquired to date is not sufficient to be conclusive. The first “Lamfalussy-type” proposals” have shown how difficult the first step is as to distinguishing between framework principles and implementing measures. For being framework directives, the draft prospectus and market abuse directives went into much detail, and this will be even more so after the amendments of the European Parliament have been incorporated. As the European Parliament will not directly have a say in decisions by the Securities Committee, it has proposed many amendments, over 100 in the case of the draft market abuse directive. Moreover, the EP may have a different view on what constitutes “framework” and what constitutes “detail” than the European Commission, as there is certainly no basic theory on this question. Framework directives under the Lamfalussy approach can thus be considered as a contradiction in terms. They

were designed to ease regulation and enforcement, but they may end up rendering this process even more complex.

An issue that is often overlooked is the role that self-regulation and disclosure can play in enforcement. In retail financial services, the European Commission is stimulating the use of ombudsmen at national level to ease the resolution of conflicts between providers and consumers. In the Lamfalussy report, the role of self-regulation was almost absent, although it plays a very important role in securities markets. Intermediaries, such as investment banks, law firms and rating agents, compete on the basis of their reputation, which contributes considerably to improve standards in securities markets regulation. The same applies for standard-setters such as accounting standards boards and professional federations.

The problem of enforcement will not diminish in the years to come, as the EU intends to enlarge with 12 new member states, 10 of which may join as early as 2004. Each of the applicant states needs to have transposed all applicable EU legislation in national law by the day of entry. Otherwise the country is bound to negotiate transition periods to the full application of specific elements of legislation. The applicant states are well advanced in the process of approximation of laws, but problems with effective enforcement may only appear at a later stage, and will undoubtedly escalate in an EU of 27.

### ***B. The need to open-up consumer financial markets***

The lack of integration of consumer financial markets is an old problem, which does not seem near to approaching a solution. The core of the problem is the difficult interaction of financial market legislation, which liberalises market access under the control of the home country and minimal harmonisation of rules, and the consumer protection legislation, which falls largely under the responsibility of the member states, and requires maximal harmonisation to allow market integration. Consumer protection legislation is, however, so vast that EU attempts to harmonise will always at some point fall short, thereby allowing a member state to argue that a product sold on a cross-border basis by a firm from another member state is not in accordance with domestic rules. The way out of this dilemma is to require member states to recognise each others' systems as equivalents. Furthermore, a sunset clause should be adopted for the application of host country rules in harmonising measures.

An example of this difficult interaction is the e-commerce directive and the draft distance selling of financial services directive. The former directive, adopted in 2000 enables on-line providers to supply services throughout the EU based on the rules of the country from which the provider effectively carries out his

activities – also called the country of origin (not necessarily the home country).<sup>6</sup> However, the directive excludes financial services contracts and host country measures that are needed to protect consumers. The applicable rules for the latter should be defined in the distance selling of financial services directive, on which a political agreement was reached in September 2001. This directive defines, in much detail, the information to be supplied to consumers before the conclusion of a contract, the form of a contract, the financial services covered, the right of withdrawal (with a cooling-off period of 14 to 30 days), and the settlement of disputes. Article 13 of the draft directive states that member states can impose additional rules on providers from countries where the distance selling directive has not been properly implemented. In practice, this provision overrules the country of origin rules of the e-commerce directive. Some member states have therefore called for a clause in the distance selling directive to ensure that, in case of disagreement, the e-commerce directive rules will apply.

### ***C. Systemic risk and crisis management***

The question of monitoring systemic risk and crisis management has been discussed frequently since the start of EMU. It is now accepted that there will be some role for the ECB and the EFC in crisis management, without it being openly formalised. Three problems are prominent: 1) who monitors? 2) the interaction between eurozone – EU, or Europe; and 3) who is responsible and who will pay?

Monitoring financial stability is, and remains, the responsibility of the national central banks, not of the ECB, under the EU Treaty. Although there is some coordination of macro-prudential supervision by the ECB's Banking Supervision Committee, which also includes non-eurozone countries, our feeling is still that there is weak monitoring at the centre, and insufficient oversight of the cross-border dimension.

On the eurozone-EU dimension, the ECB has been more pronounced. Its role is limited to the eurozone, and the coordination at EU level is weaker than it is at eurozone level. The question can be raised of whether the risk is also less significant. On central counterparties in securities clearing, the ECB has clearly indicated that they should be located in the eurozone because of the systemic dimension (ECB, 2001b). However, the ECB's role is limited to payment systems, and it has *strictu sensu* no responsibility for securities clearing.

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<sup>6</sup> The country of origin rules have also been proposed for the application of conduct of business rules in a Communication on the revision of the EU's investment services directive; see European Commission (2001a).

Three years after the start of EMU, ambiguity regarding crisis management remains. This point has been raised by many academic commentators, but also at an official level in the Brouwer reports. The ambiguity surrounding procedures and responsibilities is not seen as constructive, as it reduces confidence, accountability, and possibly the effectiveness of crisis management. The current system is seen as one of ‘improvised cooperation’. If ever a failure of a financial institution with a European-wide dimension occurs, it is likely that supervisors and national states will disagree over who is responsible and who pays. The second Brouwer report has attempted to meet these concerns by requesting national supervisory authorities to add procedures for crisis management to the bilateral Memoranda of Understanding. It also called for removing remaining legal impediments to the exchange of information among supervisors. But, for the remainder, ambiguity remains.

#### ***D. The emerging post-Lamfalussy committee structure***

The breakthrough on the Lamfalussy approach may have important implications for financial regulatory processes in the EU. The model could be followed for other sectors of financial regulation, for example, for the implementation of Basel II, but this may require adaptation to the existing Banking Advisory Committee (BAC).

The Securities Committee could in some way be considered as an embryonic Securities and Exchange Commission (SEC). The Committee will have broad decision-making powers, and will decide by qualified majority. Decisions in the Committee could thus be in opposition to the interests of certain member states.<sup>7</sup> The structure of the European SEC will, however, remain de-centralised for some time to come. The Securities Committee will be chaired by the European Commissioner in charge, but its decisions will be largely prepared by the Committee of European Securities Regulators (CESR), which will work independently from the European Commission. CESR will have its own secretariat in Paris, and is chaired by a member state representative. CESR and the European Commission will thus cooperate and compete at the same time, which should be beneficial for the quality of the regulation and its enforcement.

An important corollary of the breakthrough on the Lamfalussy approach is that a European FSA should be off the agenda. The Lamfalussy report stated that in

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<sup>7</sup> The Stockholm European Council (March 2001), while endorsing the Lamfalussy report, stated explicitly that: “The European Council notes that within the framework of the comitology decision of 28 June 1999, the Commission has committed itself (...) to avoid going against predominant views which might emerge within the Council.” The European Parliament on the other hand had to be satisfied with the promise that the Commission would take “utmost account” of its views.

case of no progress on the proposed approach, a single European Financial Services Authority (FSA) should be considered. Functional cooperation among member states will most likely be more appropriate in a European context than a European FSA. An EU FSA would not be adequate for a host of reasons, most importantly from a financial regulatory perspective. It would also be difficult to reconcile with the basic single market principles of subsidiarity, minimal harmonisation and home country control, as discussed above.

### ***E. Implementation of the Basel Review***

The Review of the Basel Capital Accord raises a variety of issues. Within the context of this paper, the most important are the transposition of Basel II in EU law, the role of the Banking Advisory Committee for technical adaptations to the directive and the impact of the Supervisory Review on the non-convergence of supervisory practices in the EU.

Basel II will become a complex EU directive. The level of technical detail in Basel II is high, which raises the question about the handling of the directive by the European Commission, the processing of the directive by the European Parliament and the EU Council, and its implementation into national law. The various interest groups have deeply entrenched positions vis-à-vis Basel, which predicts a difficult decision process and an uncertain outcome.

As with the Lamfalussy Committee, it is likely the Commission will choose a framework directive giving a Committee a high degree of powers. This will most likely become the Banking Advisory Committee, although this is not certain. The BAC has limited comitology powers so far, and is not comparable to the composition of the new Securities Committee. The latter is composed of high-level civil servants from the finance administration of the member states, whereas the BAC works with the heads of the banking supervisory authorities. Could this mean that the Securities Committee will be transformed into a form of high-level finance committee? This is a move that the European Parliament would certainly not like to see.

The convergence of supervisory practices is another priority. However, it is a question of whether pillar II of the Basel Review, whereby authorities can determine when to intervene when a bank is in trouble, will be used as an excuse for national authorities to keep supervisory practices un-coordinated. Finally, regarding the proposal for increased disclosure under pillar III of the accord, this practice is still infrequent and underdeveloped in Europe. The number of listed banks issuing half-yearly accounts in the EU is less than half the number in the US. The production of quarterly accounts by EU banks is almost non-existent, whereas it is standard in the US (Enria and Vesala, 2001, p. 29). Furthermore, disclosure raises the problem of differences in accounting conventions, but this

should now be addressed as a result of the move towards International Accounting Standards (IAS).

#### ***F. Adequate regulation and supervision of securities markets***

Most work remains on the improvement of the regulation and supervision of EU securities markets and to further harmonise rules. This is commonly accepted since the adoption of the Lamfalussy report. However, whether the outcome of this exercise will be a more harmonised and workable regulatory environment is another matter, as the reactions to the new draft directives and the number of amendments in the European Parliament have proven.

In the supervisory area, a more homogeneous structure at national level may be emerging. The draft prospectus directive requires member states to de-couple listing from trading, and to transform the listing authority in an independent supervisory agency, away from for-profit exchanges. The market abuse directive requires member states to appoint one competent independent authority to track insider trading. Both measures should thus ease convergence among, and cooperation between, supervisory authorities and facilitate market integration.

#### **IV. Conclusion: A model for Europe?**

Great progress has been achieved in creating more cooperation between supervisory authorities on all levels. The matrix of the structure of European regulatory and supervisory cooperation has been (almost) completed with the creation of the Securities Committee and more cross-sector cooperation. The ensuing structure is, however, complex. Which raises the question whether gradual change is sufficient, or whether a grand design will at some stage be needed.

A single European financial supervisory authority is, however, not the solution. Apart from the fundamental problems it raises from a financial supervisory perspective, it would also politically be very difficult to promote. A better structure for the future is to re-design the European financial system on the basis of the objectives of supervision, and to examine where more centralisation is needed. Beyond any doubt, this is most needed for reasons of financial stability. The ECB has tacitly stepped up its activity in this field, as recent developments indicate, but more may be needed and a more elevated profile may be desirable. It does, however, raise the problem of the desirability of a higher involvement of the ECB in supervisory matters, and the problem of eurozone versus the broader EU framework.

At the level of prudential supervision, the structure of cooperation is in place, but much work remains to be done. There is the streamlining of the home country principle, the upgrading of the memoranda of understanding and the

improvement of the mechanisms and quality of information exchange. The biggest issue, however, is the standardisation of the supervisory practices in the EU, where work still has to begin. The outcome of the Basel Review, and in particular its pillar II, should also indicate how this work will proceed.

At the level of conduct-of-business rules, there is probably the least need for harmonisation, but at the same time the biggest opportunity for member states to protect national markets based on various pretexts. A commonly agreed solution for the interaction of market liberalisation and consumer/investor protection rules at a general level is urgently needed.

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## **Annex**

### **EU and EEA Fora for Cooperation in Financial Regulation and Supervision**

#### **1. Banking**

##### **A. Banking Advisory Committee (BAC)**

- 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.

##### **B. 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.

C. 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.
- 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.

## **2. Securities markets**

A. Contact Committee (established 1979)

- Advisory committee, without comitology role (except for one issue, which was never touched).
- Facilitates harmonised implementation and advises the Commission on any supplements or amendments to the 1979 stock exchange admission, 1980 listing particulars, 1989 prospectus, 1989 insider dealing, 1988 major holdings and forthcoming take-over bids directives.
- Allows regular consultation between the member states on these matters.

B. UCITS Contact Committee (established 1985)

- Advisory committee, with comitology role.
- Facilitates harmonised implementation of and advises the Commission on any amendments to the 1985 UCITS directive and its 2002 updates (in which its role was enhanced).

- C. 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, functioned as Commission working group until the Securities Committee was formally established by an EU directive.
  - Advises the European Commission on regulatory and supervisory matters.
- D. CESR, formerly FESCO (established December 1997)
- Originates from Informal Group of Chairmen of EU Securities Commissions.
  - Brings together securities commissions of the EU. Functioned originally on an intergovernmental basis and with delegates from the European Economic Area (the EU, Iceland and Norway, in the context of the Forum of European Securities Commissions, FESCO).
  - 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.
  - Formally established as the Committee of European Securities Regulators (CESR) following the Lamfalussy report. The Charter was adopted on 11 September 2001. It will function as fully independent Committee with its own secretariat and is chaired by a member state representative.
- E. Securities Committee (established September 2001)
- High-level committee with implementing powers for elements of directives to be adopted as further to the Lamfalussy report.
  - Was rejected twice before because of procedural problems and sensitivity of European Parliament to “comitology”.
  - Relunched in the Commission’s financial services action plan (May 1999), formal decision taken in June 2001
  - First meeting under the chairmanship of European Commissioner for Internal Market, Frits Bolkestein in September 2001.
  - Operational since the approval by the European Parliament of the von Wogau report on 5 February 2002.

### **3. Insurance**

#### **A. 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.

#### **B. 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.

### **4. Cross-sector fora**

#### **A. Commission Mixed Technical Group on Financial Conglomerates**

- Established in 1999, involving representatives of the sectoral regulatory committees.
- Considers proposals for improving the framework of information sharing between supervisors and co-ordination of prudential framework on a cross-sectoral and cross-border basis.

#### **B. Cross-Sectoral Roundtable of Regulators**

- Established in 2001 to discuss cross-sectoral supervisory problems.

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