Cross-border financial supervision in Europe: Goals and transition paths*

By David G Mayes
David Mayes is Adviser to the Board at the Bank of Finland

In this paper, I consider how the authorities in European countries might work together to ensure a framework for the efficient supervision of cross-border banks that are of systemic importance in at least one country, in a way that enables each country to claim credibly that it will be able to maintain financial stability. After reviewing the options, I argue that a collegial approach to supervision, where all the authorities are jointly responsible under a strengthened lead supervisor, might work well in normal times. However, maintaining financial stability calls for some form of hard-law international agreement among the partners on how problems will be avoided and handled, not simply a Memorandum of Understanding. This involves an explicit commitment to Structured Early Intervention and Resolution, with rules for Prompt Corrective Action and a new legal basis whereby the resolution of a bank in difficulty is feasible without a break in its operations, without a taxpayer bailout and with a requirement to minimise losses, in a manner similar to that in the United States. While in the short run, with a small number of banks involved, the lead country could be responsible for resolution on a case-by-case basis, in the longer run a limited European Deposit Insurance Corporation might be the way to go.

If we were discussing an ideal world for handling a European financial supervision that could cope with large, complex cross-border institutions, the task would be relatively straightforward. Clearly, everything would be much simpler if we had a single legal framework and a set of detailed regulations that were simply translated into the various national languages.

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We could then have a fairly straightforward discussion about how to handle supervision. We would face the usual choice about whether a single organisation should handle every aspect or whether there should be a separation between prudential and conduct-of-business issues.[1] (This has been labelled the 'Twin Peaks' approach; see Taylor (1995) for example.) In the same way, we can discuss whether there should be separate organisations to supervise the overall holding company, banks within it, insurance and other financial services. We can also debate whether central banks should be supervisory institutions at any of these levels of concentration.[2] Clearly, this gives us the opportunity to have an entire mountain range and various proposals for more peaks have emerged – Di Giorgio and Di Noia, (2003) have four.[3]

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In other words, the debate that occurs within single national jurisdictions could be raised to the international level. But even at the national level, virtually every possible combination of concentration and separation of responsibilities already exists in practice, with firm advocates of the merits of each of them. That debate is extensive in its own right. Furthermore, since Europe is a large area, it would be quite reasonable to expect that some hierarchy in the organisation of supervision would be appropriate. Even if the organisation straddled the boundaries of lower level jurisdiction, as is the case for several Federal Reserve districts in the US, some regional division would be necessary to keep the administration manageable, ensure staff can speak the local language and be familiar with local conventions, facilitate relationships and so on. In this way, supervisory approaches might very well be devised with a distinction between supervised institutions with just a regional presence and those that extend across regions. The first group could be assigned to regional supervisors, while the second would require supervisors in a number of regions and/or a Europe-wide supervisor or co-ordination arrangement.

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However, we are a long way from that ideal world. Even if we found the target reasonable, implementing the changes would take time and we would have to decide on the likely time horizon for achieving that objective, as it would affect the process. This might make sense in a Nordic context. Current legislation, institutions and approaches are sufficiently similar for a single approach to be feasible over a ten or twenty year hori-

[1] Schoenmaker (2004, pp.434–7) gives a clear exposition of the synergies that can be achieved by combining the functions and the conflicts of interest that can arise.

[2] Currently, of course, there is also diversity in the organisation of the central banking system in Europe; only some countries are members of the EU, which makes their national central bank a part of the ESCB, and a subset of those countries are a part of the euro area, which means that they also participate in the principal activities assembled under the European Central Bank. See Goodhart (2000) for a helpful set of papers considering how the role of lender of last resort provided by central banks and the shared responsibility for financial stability can best be combined in the EU.

[3] The article also contains a helpful summary of the previous literature; see their fn. 8 for a list of references.

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zon, depending on one's optimism about the speed of legislative change. For Europe as a whole, however, the time horizon is so long that the political destination is quite likely to change substantially from what is currently thought likely. It thus makes more sense to design a set of institutional arrangements that is appropriate for managing a process of change in a world of increasing cross-border activity, increasing economic, political and legal integration but without any strong regard for where it will end up. Thus, the steps on the way would stand on their own merits, not just on the merits of the hoped-for end point. While the discussion could be treated as a problem for the future in several EU/EEA countries, in the Nordic-Baltic region it has been brought firmly into the present by Nordea's announcement that it hopes to take advantage of the European Company Directive and restructure itself as a single entity based in Sweden with branches rather than subsidiaries in the other countries in the region (see Mayes, 2005, for a more detailed description). Nordea is already of systemic importance in Denmark, Estonia, Finland, Norway and Sweden and this structural change would completely alter the balance of supervisory responsibilities between the home and the host countries without any matching change in the responsibilities for financial stability. However, because Nordea's shares of the respective markets vary quite considerably, authorities might well disagree about the effort that should be made to avoid various problems. Holthausen and Rønde (2004) show how the outcomes would be clearly suboptimal if supervisors co-operate in a manner whereby they simply pursue their own national interests. A means of coping with this new circumstance needs to be negotiated within the next couple of years and is already well under way (Mayes, 2006).

TABLE 1. NORDEA'S MARKET SHARES IN THE NORDIC COUNTRIES

	Denmark	Finland	Norway	Sweden
Mortgage lending	17%	32%	12%	16%
Consumer lending	15%	31%	11%	9%
Personal deposits	22%	33%	8%	18%
Corporate lending	19%	35%	16%	14%
Corporate deposits	22%	37%	16%	21%
Investment funds	20%	26%	8%	14%
Life & pension	15%	28%	7%	3%
Brokerage	17%	5%	3%	3%

Source: Finnish Financial Supervision Authority.

The Lamfalussy process for financial integration might be seen in the same light. Rather than design a single system, the intention is to harmonise many major facets of the existing systems sufficiently for them to operate together effectively and fairly. What converges is then a matter for market and regulatory processes. There is a tendency to assume that convergence is generally likely; beyond a certain point, however, markets tend to thrive on variety, except as regards common standards for networks, as in various parts of the financial infrastructure.

Padoa-Schioppa (2004) argues that current processes of moving to a single 'rule book' and 'supervisory convergence' through CEBS (the Committee of European Banking Supervisors) could actually get us to the desired position. In this position, a cross-border institution could organise itself to comply with a single set of rules in all the EU/EEA countries in which it operates. He stops short of the second requirement, suggested by the European Financial Services Round Table (EFR, 2004), that the institution could also deal with a single *lead* supervisor that co-ordinates the activities of the network of responsible supervisors. He repeats the current arrangement of having a *consolidating* supervisor that forms a coherent whole out of the parts of the supervisory process and is responsible for deciding on the approach to be permitted under Basel 2 on capital adequacy and risk management. Schoenmaker and Oosterloo (2004) make the same point – a lead supervisor is necessary and the current 'home-host' arrangements are insufficient.

In this paper I review the available range of plausible options and conclude that it is necessary to go beyond even the EFR (2004) proposals and agree on a single system, applicable to any cross-border financial group, in which a single authority has the lead responsibility, not just for supervision but for taking prompt corrective action and ultimately intervening to resolve any solvency or capital adequacy problems. However, in exercising that lead, the authority must consider the financial stability concerns of all the countries involved. I conclude that the simplest solution would be to have a European level agency, established for this purpose, but that it would be possible, at least in the short run, to operate case by case with the current system. If a European level, with a built-in framework for balancing interests, is not introduced, the existing supervisors need to work together as a 'college' or 'network' led by the home country, with a shared information base and a means of resolving their differences, including the provision of restitution if required.

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Home-host: an outdated approach?

Attributing motives retrospectively is easy but it does seem likely that when the home-country responsibility principle for supervising cross-border activity was drawn up, it was expected that direct cross-border activity would be small and multi-country institutions would operate in other markets largely through subsidiaries.[4] Thus, rather than being clearly multinational companies, international banking groups would be more like a 'multidomestic' set of companies that operate relatively separately (Mayes, 1991, 1997) and have reasonably restricted relationships both with each other and with their parent. The more effective the national legal, fiscal and administrative barriers, the more this separation would be perpetuated.

The home country responsibility for regulating and supervising operations of branches in the host countries is not generally followed outside the EU.

Thus, under the current system, the home country is responsible for regulating and supervising operations in the home country. How this is done will depend somewhat on the structure of the institution, which can be quite complex when there is a range of subsidiaries involved in a variety of financial and non-financial activities. Since we are concentrating on prudential supervision, the same supervisory structure will apply both to direct cross-border activities performed from the home country and to activities performed in other EU/EEA countries through branches of a legal entity in the home country. However, those activities have to be performed according to the rules of the host country in a conduct-of-business sense. We immediately have a lack of continuity, because outside the EU/EEA the host country would normally supervise the activity of a branch. In this context, the EU/EEA approach seems more logical as it is the legal entity's total assets and liabilities that would normally be relevant for meeting claims or obligations. However, their location and indeed currency denomination will affect their usefulness. Outside the EU/EEA there could also be a territorial approach to the handling of assets in the event of insolvency.

Although there is an important legal distinction between branches and subsidiaries, in many respects the practical differences for ongoing supervision may be much more limited.

Inside the EU/EEA, the host country is not able to compel the institution to operate as a locally incorporated subsidiary; elsewhere it could and thereby have the legal neatness of an operation with a separate asset base. But although there is an important legal distinction between branches and subsidiaries, in many respects the practical differences for ongoing supervision may be much more limited. Indeed, they can be reversed. A bank may run its subsidiaries as a highly integrated operation, for instance with integrated risk management, a single treasury operation, common products and so on, giving local management very little independent scope for action. Alternatively, a branch may have substantial autonomy and manage business that is very different from that in the

[4] The home country is the label for the country in which the financial institution or at least its EU/EEA operations is headquartered, host countries being those other countries in which the institution carries out activities. The headquarter country is not immutable. While it needs to be a centre where an institution has a presence, a large majority of the activities can take place in a range of host countries. If the home country's characteristics, such as supervisory or tax regimes, are unattractive compared to those of its major hosts, the headquarters could be expected to migrate if the relative benefits seemed likely to be long term and exceeded the switching costs.

home country. The important distinction may concern insolvency rather than operation. Host countries may be supervising entities whose real management is outside their jurisdiction, while home countries may be supervising branches where the entire operation is effectively abroad.

While it may make sense for the supervisory responsibilities for largely independent entities to be aggregated under a consolidating or lead supervisor, more integrated supervision would probably be more appropriate for entities that are largely integrated. In a complex organisation that is running a number of rather different financial activities, this might involve having one supervisor for the banking activities and another for, say, insurance activities, with consolidation for the group as a whole. However, such rather pragmatic solutions would be rather difficult to build into a legal framework and might encourage undue regulatory arbitrage.

Clearly, then, although current supervisory structures may match legal structures of firms, this does not ensure that the home-host approach meets the needs for which it was designed. It is not necessarily best designed for facilitating the creation of cross-border entities in Europe. Still less is it necessarily well-designed for enabling high quality supervision and the management of prudential risk.

The Committee of European Banking Supervisors (CEBS) is working steadily to put together an efficient means of getting the various supervisors involved in a cross-border group in the framework of the new Capital Requirements Directive (CRD) implementing the Basel 2 framework in the EU/EEA. The guidelines (CEBS, 2006) are designed to promote cooperation and the sharing of information and hence to encourage convergence in supervisory requirements. They help explain how to organise the Supervisory Review Process under the CRD. A detailed set of tables spells out what the roles of the home and the host supervisors are, depending on the circumstances. They do not prescribe a specific approach to maximising the benefits from the host supervisors' detailed local knowledge and the consolidating (home) supervisor's view of the group as a whole. The hope is that by working together, the supervisors will achieve consensus and the outcomes that each of them needs. This is not the same as articulating how the review for the group as a whole can best be undertaken as a co-operative exercise among the members of the supervisory college.

An inter-related problem

When discussing the most suitable approach to supervision, there is a tendency to start from a particular standpoint: for example, what would

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make best sense to current supervisors in the execution of their tasks; what would be most efficient for the supervised institution in the exercise of its business. Indeed, the suitable conduct of supervision has often been treated separately from the suitable means of handling problems, should they occur.[5] Since supervision is the ongoing process and problems are rare, the former tends to drive the latter, whereas the point of having supervision is to make problems manageable. Furthermore, it is clearly not possible to discuss one part of the regulatory framework without considering the others. If there are unresolvable deficiencies in the design of problem resolution or of deposit and other insurance, that could have implications for the appropriate structure of supervision.

Arguing the case backwards, the framework needs to cope with

1. insolvency or sufficiently low capitalisation for the authorities to feel compelled to intervene because of systemic risks
2. insolvency or sufficiently low capitalisation for the authorities to feel compelled to withdraw the licence to trade
3. low capitalisation, breaching regulatory requirements, necessitating prompt corrective action to restore compliance
4. poor performance, requiring some change in ownership or management action to improve performance – but no regulatory breach
5. normal circumstances, under which both the market and the supervisors are satisfied with performance.

In most EU/EEA countries, responsibility rests primarily with the supervisor in every stage, although where the supervisor is not the central bank, the latter may be providing emergency assistance to one or more institutions, providing they are thought solvent, and the government may create special-purpose vehicles for handling serious problems – in the form of investment agencies, supplementary insurance funds, asset management corporations etc. The deposit insurance fund normally plays a passive role and in many countries has almost no staff of its own.

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This is in contrast to the United States and a number of other countries, where a different agency, in the US case the FDIC (Federal Deposit Insurance Corporation), cuts in once problems are threatening to emerge. This counters one of the incentive problems supervisors can face. A supervisor primarily charged with ensuring the good running of the system faces a dilemma once an institution starts getting into difficulties. If it can help the institution recover and recapitalise with the instruments at its

5 This is emphasised by the two Brouwer Reports (2000, 2001), one on relationships among authorities in Europe in normal times and the other on crisis management.

command, then it can successfully prevent a difficulty from turning into a default or a failure. Even if the mandate is silent on the point, in practice institutional failure may be equated with supervisory failure. In many countries this has tended to encourage forbearance and allowed problems to build up.

If, as in the United States, a second organisation is involved with the objective of minimising losses should a problem occur (in the US case it is to minimise the loss to the deposit insurance fund), then the incentive to keep an institution in being and refrain from really harsh action will be much more limited. It will not be zero; before the 1991 FDICIA (Federal Deposit Insurance Corporation Improvement Act), the FDIC also tended to keep institutions alive (Benston and Kaufman, 1994). In part this was because they are worth more 'alive' than dead even if they are technically insolvent (Guttentag and Herring, 1983). Hence intervention as the problem worsened was mandated by FDICIA, giving the FDIC relatively limited scope to defer action or run institutions itself. This framework of mandatory Structured Early Intervention and Resolution (SEIR) and Prompt Corrective Action (PCA) is also missing in general in the European environment. Action is indeed required under present rules but its timing and nature, as well as the degree of discretion involved, vary considerably across the member states (Nieto and Wall, 2005). Furthermore, the ability of the authorities to intervene early in the EU/EEA is more limited than in the US. In the US, the FDIC is obliged to step in when the leverage ratio falls below 2%. In the EU, however, the authorities are often not in a position to step in and take over a bank as long as its shareholder value is positive even if it is seriously undercapitalised; moreover, the Pafitis case (Hadjiemmanuil, 2003) imposes limits on action, making minimisation of the cost to the deposit insurance fund more difficult.[6] Experience from the Norwegian crisis (Moe et al, 2004) illustrates the importance of being able to intervene early, compared to what was feasible in Finland and Sweden during their crises.

The fact that these issues in the event of difficulty have not been sorted out has implications for decisions about the operation of supervision across borders. In a cross-border environment, not only do the authorities need to be able to act efficiently and effectively under each of the five circumstances listed above but this ability needs to be credible and predictable both to the authorities of the countries involved and to the supervised entities, so that moral hazard is limited. It is by no means clear that this is the case at present. Certainly no government would be

[6] There are some specific difficulties for cross-border deposit insurance that are only briefly touched on here (Mayes, 2005; Mayes et al., forthcoming).

prepared to pre-commit to burden-sharing arrangements without being convinced that at all stages the system would manage the risk and minimise the potential losses.

In the preceding paragraphs I have suggested that there are clear problems with stages two and three. There are also reasons for being somewhat cautious about the market's ability to exert effective discipline in many cases in stage four. The financial institution may not be openly traded for a variety of reasons: because it is part of a wider entity, because it is privately owned, because it is a mutual, because it is state owned, etc. All of this increases the need for supervisors to try to ensure that the system operates well in stage five and hence places greater weight on prevention as opposed to insurance, risk management and resolution of problems.

I have deliberately emphasised these subsequent steps because some of the arguments put forward for arrangements among supervisors in the EU/EEA concern problem resolution rather than supervision per se. If problem resolution can be addressed head on, then it may be more possible to arrive at workable and less complex arrangements for supervision. However, I have deliberately set aside one of the most difficult problems, which is the treatment of systemically important institutions or institutions with systemic functions (Hüpkes, 2005). This is the biggest conundrum for supervisors and has a major impact on the plausible variety of arrangements for cross-border supervision. It is therefore the subject of the next section.

One helpfully comprehensive approach to these issues is the November 2005 Statement by the European Shadow Financial Regulatory Committee (ESFRC, 2005), which envisages three main vehicles:

– a European Banking Oversight Board that would monitor national discretionary decisions that have cross-border implications – they cite the ABN-AMRO-Antonveneta case by way of illustration
– a system of Prompt Corrective Action in all member states
– a European Standing Committee on Crisis Management.

It is no surprise that the ESFRC should be addressing these issues, as their very first statement (ESFRC, 1998) was on 'Dealing with Problem Banks in Europe' and focused on the creation of an SEIR regime in Europe of which PCA forms an important part. What their November 2005 Statement makes clear is their dissatisfaction with the (lack of) progress on most of these key issues. They want to see formal procedures established in order to achieve proper accountability for supervisors in a cross-border framework. Hüpkes et al. (2005) also look at this issue of accountability in a wider context.

Even if it were thought desirable, a simple transposition of the US system to the EU would not be possible (Eisenbeis and Kaufman, 2005). A crucial difference from the US system is the absence of a federal level of insurance or other funding on which to draw in the event of difficulty – the funds will have to come from the member states and other national sources. This applies to deposit insurance as well as to fiscal transfers. So there needs to be a precise, sovereign interest in the problem and the solution. Even a European level solution would have to differ from the federal solution in the US. However, it does not obviate the need for a comprehensive approach, as the ESFRC suggest. It is possible, however, that the creation of a European equivalent to the FDIC would be the most effective EU/EEA level institution to start with.

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Too big

So far, the concern has simply been that the key issue for prudential supervision of institutions operating cross-border is that the supervision itself should be done efficiently and effectively. We have seen that there are strong reservations as to whether, in present circumstances, problems can be resolved, or in some cases avoided, in a manner that minimises the losses to the insurance fund or more widely to creditors and depositors. However, with the exception of drawing on the deposit insurance fund, which may impose some short-run costs, to date there has been no question of using public money. Nor has there been any doubt that the institutions involved or the functions they perform are sufficiently important for their closure to have significant knock-on costs with a serious direct spillover onto other financial institutions or onto confidence in the banking system in general. In those circumstances, the systemic stability of the financial system would be threatened.

The authorities in each country normally have an explicit commitment to maintain the financial system's stability, though what that implies remains largely undefined (Schinasi, 2005). The cross-border arrangements for supervision have to be such as to enable that function to be exercised. This is not just a matter of managing current circumstances but also of offering a credible approach to future events, particularly to those that no-one can currently envisage. It is not quite clear what this entails but the key ingredients appear to be: adequate access to *information* before the event to detect incipient pressures, and adequate *powers* in the event to *take action* to maintain stability (Mayes and Vesala, 2000). It

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is rather unlikely that the current home-host arrangements can deliver that result.

The information issue is perhaps easier to solve than the power to act. It entails national supervisors having access to the same range of information in a cross-border case as they do in a domestic case. As Schinasi (2005) makes clear, in addition to a variety of macro-economic and industry information that can be obtained by an external institution (such as a central bank), this includes supervisory information. This implies access to a common database on important cross-border institutions and participation in the supervision as such, so that the national supervisor has an adequate opportunity of detecting the signals. This implies a very different relationship from the current MoUs (Memoranda of Understanding) among supervisors on information sharing,[7] but it does not necessarily entail changing the existing structure (Vesala, 2005). There would need to be rather different working relationships, which are essentially much closer. However, Basel 2 is already requiring a move in that direction, such that, inter alia, the lead (consolidating) supervisor can establish a single approach to risk management for the financial group as a whole. This may require some legislative change if disclosure rules currently prevent foreign supervisors from participating in the supervisory process and having access to the resulting information.

The single approach to the risk management of the financial group, 'Enterprise Risk Management' as Schmidt Bies (2004) describes it, clearly makes sense, as entities can be created within the structure of the group 'to transfer and fund assets [that] may or may not be consolidated for accounting purposes, depending on their structure' (p.1). However, while supervisors may well have a common view on how the risks within the group as a whole should be handled, there may still be conflicts of interest when it comes to the treatment of problems. Irrespective of size, there are going to be disputes because there may well be a country-by-country mismatch between the distribution of losses and the distribution of their causes. Without common supervision of the entity, there may be little chance of feeling that the common pool, single entity approach to handling the problems will be equitable.[8] However, as soon as an institution reaches systemic proportions (as illustrated by Nordea), the conflict of interest may be much greater, as the systemic effect may not apply in

7 Holthausen and Rønde (2004) suggest why the current system may not result in adequate information sharing.

8 Deposit insurance under current rules may complicate this as it follows the home-host divisions and is not pooled over the entire area in which the bank does business. Hence, if it is contributory from the rest of the banking system, the cost of meeting a claim could fall rather unevenly, as the customers of branches in other countries will be covered by the banking system in the home country. This is a clear contributor to making some banks 'too big to save' in the sense that the losses are concentrated disproportionately on the home country, perhaps beyond the point that it is prepared to bear.

some countries. If the failing bank is systemic in a host country but not in the home country, simple aggregation would lead to accepting closure and triggering the systemic event in the host country. Similarly, a decision to 'save' an institution because it is sufficiently systemic will raise the question of the extent to which countries that would have been quite willing to let the enterprise fail because it was not systemic in their jurisdiction will want to contribute to the costs of resolving it.

It is thus immediately apparent that if a financial institution or some of its activities become in some sense 'too big to fail' in any of the jurisdictions involved, then it poses a special problem, not just for resolution but also for supervision. In this respect, the US cannot provide a direct indication of the way forward. Any exception there from the provision that the FDIC should seek a least-cost solution to its funds is a national (federal) issue, not a state or regional one. It is also an extreme circumstance and has not (yet) been invoked.[9] The number of institutions to which it might apply may be of the order of 10 to 20 (Stern and Feldman, 2004). In the European environment there is no federal level for spreading losses and less cross-border insurance of the consequences through the structure of asset portfolios and activities. As a result, localised (national) systemic events are more likely and require special handling arrangements where they relate to cross-border institutions. Thus, the subject here is not necessarily EU level systemic crises but national systemic events involving cross-border institutions. (Of course, the handling of possible EU level crises must be and is already being addressed.) One might choose to label these issues 'European', since both prior supervision and ex-post resolution need to be viewed in a cross-border framework. If they involved a smaller member state, such as Estonia, a European level event could then be considerably smaller than what in the US would constitute a national level event requiring an exception to the normal FDIC requirements.

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Even so, a look at the analysis in Schoenmaker and Oosterloo (2006) and elsewhere indicates that the number of EU/EEA institutions which any supervisor would judge to be systemic from their point of view but not under their adequate control (as either a home or a host) is relatively limited at present. Schoenmaker and Oosterloo suggest that only some of the largest 30 banks in Europe are sufficiently cross-border to generate home-host problems. They classify nine of them as European and another four as primarily international. Only 25 are identified as having more than 10 per cent of their business outside the home country and 19 as having more than 10 per cent in other 'European' countries. However, their table

[9] It requires the agreement of the Chairman of the Federal Reserve, the Comptroller of the Currency and the Secretary of the Treasury.

does not include some directly cross-border institutions that are systemic in a range of countries, like Euroclear, CLS or SWIFT, where arrangements have already had to be made to establish adequate involvement. Nor do they necessarily pick up some of the smaller banks that play an important role in certain other countries. A foreign bank based in a large country may pose systemic concerns in a small country even though its foreign activity is trivial compared to its domestic activity.

It is worth more than a footnote to point out that, by confining the discussion to the current EU/EEA, the extent of the problem is artificially limited by the jurisdiction of the EU/EEA countries. The problem certainly extends to immediate neighbours, such as Switzerland, the Balkans and Turkey. It would be inappropriate to neglect the concerns of a country whose membership is a possibility even a long time ahead. Similarly, some of the largest institutions in the US are deeply involved in the European financial system. Nevertheless, even if we take a fairly wide view, are forward-looking and assume that trends towards cross-border activity will continue, the institutions that generate external systemic concerns are countable and do not call for a vast additional organisation. Counting institutions is clearly a very misleading measure of size, since these are the largest. We are in effect talking about virtually the whole of the Estonian banking system, the major parts of the banking systems in the Czech Republic, Hungary, Slovakia, Lithuania, Poland and Latvia, potentially more than half in Finland and Malta and significant proportions elsewhere, covering all the member states one way or another.

Whenever an institution attains the potential to cause systemic problems, the authorities concerned could be required to assess the problem and state how they propose to handle it.

Stern and Feldman (2005) have suggested that in the US, whenever a merger (or other change in financial holding company structure) could potentially lead to systemic problems, the Federal Reserve should first have to state the possible extent of such problems and how they would be handled. The implication here is that because such institutions place an extra cost on the taxpayer and insurance funds in the event of problems, they should pay a higher premium for this. To some extent, that would offset their gain from the lower cost of funds that being thought too big to fail confers (Granlund, 2003; Stern and Feldman, 2004). A similar arrangement could be applied in the EU/EEA. Whenever an institution attains the potential to cause systemic problems, the authorities concerned could be required to assess the problem and state how they propose to handle it. That would at least clearly separate financial institutions into two groups: those for which there is thought to be a cross-border systemic issue and those for which there is not.

This would be a considerable advance on the current situation: where the problem exists but the question of how to handle it is treated as a secondary matter. Since it is just a contingency, there is always a chance of discussion being unnecessary. This greatly increases the likelihood that a full discussion will not get under way until the first systemic event has revealed the difficulties. In addition to institutions that are ‘too big to fail’ in the traditional sense, there are currently others that are too complex or cross-border to be resolved fast enough without a crisis or public sector intervention, as well as others that are potentially ‘too big to save’ from the point of view of the home country. The latter case has been recognised explicitly by Switzerland (in effect with respect to UBS and Credit Suisse), which for deposit insurance payouts has imposed a cap of CH4bn for a single event. All this needs to be addressed in the EU/EEA.

The realistic options

In sorting out a way forward, it is thus worth restricting the problem. Most banks and other financial institutions are purely domestic or operating across borders to an extent that would make a traditional domestic-driven approach satisfactory to all parties. A small number of banks but a much larger proportion of assets and transactions are sufficiently big and cross-border to pose a regulatory and supervisory problem. They are a problem because in one or more of the countries in which they operate they are sufficiently important for the authorities concerned to be unwilling to see all or some of their activities cease abruptly, because that would cause unacceptable losses or disruption of the financial system in the area under their responsibility. This distinction between the institution and its activities is important. As Hüpkes (2004) points out, the authorities may be relatively unconcerned about much of an institution's business, which can survive a substantial pause without generating systemic consequences.

As we have noted, this second group is a countable number. Padoa-Schioppa (2004) suggests around 40 banks, Srejber and Noréus (2005) slightly more. Schoenmaker and Oosterloo (2006) consider the top 30 banks in Europe and find that some of them do not fall into this category. Fortunately, we do not yet have enough observations to decide when or under what circumstances a bank on its own constitutes a potential ‘systemic’ problem. Stern and Feldman (2004) suggest that in the US the number of banks in that position is not much more than the top 10. However, political tolerance is likely to be lower than the levels indicated by more objective studies of potential contagion. Hence the numbers might be larger.

This leaves a middle group where cross-border activities are non-trivial but do not amount to a systemic threat. In many respects, the problem for this third group is inverted. Supervisors may be able to live with the arrangements they have or foresee in the next few years, whereas the banks want a much more integrated approach to supervision to enable them to reduce compliance costs and rationalise operations across Europe to a much greater extent.

If our study of cross-border arrangements is confined to the second group, where systemic matters and burden-sharing among countries become a significant issue, then case-by-case arrangements are possible, certainly in the short run, according to the circumstances and the urgency perceived by the supervisors concerned. Once we include the third group, it becomes more difficult to envisage some sort of voluntary ad hoc arrangements that go beyond the existing legal requirements, and the framework needs to be changed.[10] Most of the schemes that do not involve a European level supervisor consider case-by-case arrangements under generalised principles. Depending on one's point of view, that is either a pragmatic approach to the considerable inherent variation in circumstances or a failure to grasp the profound difficulties involved.

Rather than create a new classification scheme, I prefer to build on the two-way classification developed by Schoenmaker and Oosterloo (2006).

Rather than create a new classification scheme, I prefer to build on the two-way classification developed by Schoenmaker and Oosterloo (2006). As its first dimension, it provides a neat categorisation of the main options for a more general scheme (Table 1):[11]

A continue with a version of the current home-host arrangement
B make the home country the lead supervisor
C make the home country the lead supervisor but find some means of their taking the interests of the host countries into account
D go to a European level system where the interests of both home and host countries are explicitly balanced
E go to a host supervisor arrangement

and, as the other dimension, a set of five criteria by which one might want to judge the schemes:[12]

1. *effectiveness* of supervision in the sense that both all the parts and the group as a whole are properly covered

[10] Padoa-Schioppa (2004) points out an obvious solution to this, again similar to the US approach, drawing on the example of Italy. A European-level supervisor would be required for groups that extend across borders and have a systemic implication. Home-host or one of the other home leadership approaches could be used for other cross-border activity and purely national for cases where there is no cross-border interest.

[11] Srejber and Noréus (2005) also explore options B, C and D as alternatives to A, which they see coming under strain.

[12] Other criteria have been advanced. Di Giorgio and Di Noia (2003), for example, suggest stability, equitable resource distribution and efficiency, where their concept of efficiency applies to the economic system as a whole, not just supervision. They also stress ensuring competition rather than competitiveness.

2. *efficiency* of supervision in the sense that duplication or overlaps are avoided
3. *financial stability* concerns of all of the parties stemming from a failure of the institution are addressed
4. *competitiveness* in the sense that there is a level playing field where domestic and foreign institutions face a similar regulatory burden
5. *proximity* in the sense that the supervisor(s) are close to the main activities of the institution.

TABLE 2. STRUCTURE OF FINANCIAL SUPERVISION: POLICY OPTIONS

Supervisory structure	Criteria				
	1. Effectiveness of supervision	2. Efficiency of supervision	3. Financial stability	4. Competitiveness of financial firms	5. Proximity to financial firms
A. Home and Host (current system)	+	+/–	+/–	+/–	+
B. Home on the basis of a national mandate	+	+	-	+	+
C. Home on the basis of a European mandate	+	+	+	+	+
D. Central body on the basis of a European mandate	+	+	+	+	–
E. Host on the basis of a national mandate	+/–	+	–	–	+

Source: Schoenmaker and Oosterloo (2006)

In the above I have adapted the phraseology used by Schoenmaker and Oosterloo (2006) to make the issues stand out a little more sharply. However, the conclusion from this analysis is straightforward. A system run by a home supervisor who takes into account the (national) concerns of the other countries involved is both the best of the five schemes and appears to meet all of the criteria.

Schoenmaker and Oosterloo (2006) consider that a system run by a home supervisor who takes into account the (national) concerns of the other countries involved is both the best of the five schemes and appears to meet all of the criteria.

Many aspects of this analysis are debatable but our starting point is the conclusion that national concerns for financial stability must be taken into account and this is not clearly achieved with the current home-host regime. Again I shall avoid exploring the clearly suboptimal cases and concentrate on the areas where a reasonable compromise among the competing objectives might be achieved. Three key questions here are:

– Is it possible to reform the home-host regime within the current framework so that it performs adequately?

– How could one ensure that a home supervisor takes the other countries' national needs into account?
– Would it be possible to introduce a European level supervisor in a way that would meet all the concerns?

I interpret the underlying differences behind the first two questions to be

(a) that the second requires a specific international legal agreement in the form of, say, a directive or regulation at the EU level, whereas the first simply requires some appropriate soft-law arrangement among the countries concerned, either in the form of a series of institution-specific agreements or multilateral agreements covering any institutions, functions or circumstances that might lead to cross-border systemic issues on which the interests of the different countries may conflict.
(b) that the second entails a much stronger role for the home or lead supervisor.

Unfortunately, these two issues are somewhat intertwined, so it is not possible to discuss one without introducing some of the other.

WHAT SORT OF LEAD SUPERVISOR?

In a home-host environment where the institution operates through subsidiaries or extends across the boundaries of supervisory responsibility, more than one prudential supervisor will be involved either domestically or internationally.

In a home-host environment where the institution operates through subsidiaries or extends across the boundaries of supervisory responsibility, more than one prudential supervisor will be involved either domestically or internationally. Hence, some form of agreement among supervisors will be required and there will need to be a designated responsibility for supervising the entity as a whole. However, even if the organisation were unitary, which is not a normal case, there still needs to be a relationship between the sole supervisor (in the home country) and host-country authorities that perceive the institution as involving systemic issues.

This sole supervisor case helps polarise the issues over which there has to be an agreement. Three main areas of agreement are required:

(i) the supervisor needs to provide host country authorities with sufficient *information* to make them feel comfortable about financial stability (this issue of financial stability is the only column in Table 1 where a minus sign distinguishes row B from row C).
(ii) the supervisor has in place a set of rules for standards of prudential behaviour, their monitoring and their enforcement, with which host authorities feel comfortable. Host authorities need to be convinced

that the home authority will apply as good standards to supervision as they would.

(iii) Host authorities need to feel that actions which will be taken if something starts to go wrong will be similar to what they would have done, that they will be treated fairly compared to the other interests in play and that special systemic concerns will be allowed for.[13]

Of these, the first is probably the easiest to handle but is not without problems. The requisite conversations and information flows are the same as would occur between supervisors and those responsible for financial stability in the national environment (Srejber and Noréus, 2005). One difficulty is that this inherently includes information about the financial group's activities outside the country. The environment in which stability needs to be judged is extended. This does pose problems of confidentiality that may require legislative changes or at least some means of including the host country authorities in the ambit of confidential disclosure. However, it is debatable whether the understanding can be built up without participation in the supervisory team. Direct contact with the directors and management and a possibility of comparing with the other major players in the sector could be necessary.

As soon as subsidiaries are involved, supervision automatically includes the host country. So the question is then how the supervisors should best work together. A highly hierarchical arrangement could hamper an understanding of the behaviour of the group as a whole. This leads directly to Vesala's (2005) suggestion of a 'college of supervisors' under the leadership of the home supervisor, rather than collation by the home supervisor of information from the hosts and from its own direct supervision.[14] This could be amplified by practical co-operation through the delegation of tasks among supervisors, thereby increasing efficiency, utilising local knowledge/skills and easing the burden on the supervised.

CEBS (2006, para 46) has gone a long way in spelling out the 'essential information' that should be communicated by both home and host supervisors on their own initiative to meet each other's needs. This relates

[13] Meeting these criteria is clearly possible. Nordea Finland is of systemic magnitude in Estonia, yet operates there as a branch. The Finnish and Estonian authorities have been able to agree on its continued supervision following Estonia's accession to the EU in May 2004.

[14] As is common in this area, people use the same words but with different meanings. CEBS (2006) and EFR (2004) also refer to 'colleges' but apart from signifying a group of people who need to arrive at a joint decision, it is not clear how far their understandings of the concept coincide. Agreement in any body normally means that if the body is to function, the minority will have to give way on certain issues. There are various ways of achieving such agreement, from a simple majority to consensus. There can also be key issues on which there is a right of veto. One might expect a veto could apply in the case of small countries with systemic concerns, otherwise they might always be out-voted. Most proposals are non-specific on this point because a small host has no way of opting out – at least not without leaving the EU, which destroys the point. In CEBS (2006) it is simply assumed that the necessary agreements will be reached.

CEBS has gone a long way in spelling out the 'essential information' that should be communicated by both home and host supervisors on their own initiative to meet each other's needs.

to changes in structure, changes in reporting by the institution and potential spillovers of difficulties. Looking at this simply from the viewpoint of the host misses the fact that the home supervisor also needs a highly co-ordinated operation in a framework where the institution is centralising various activities. There is a need to co-ordinate inspections across the different parts of the group. Moreover, since much of the disclosure and market discipline is applied only at group level, where this requires open market shareholding and the raising of subordinated debt, the lead supervisor's role should be stronger than 'consolidation'. This implies a need to move from aggregating entity and functional supervision to what Schmidt Bies (2004) describes as an enterprise or group risk management basis. This accordingly takes us from the problem of providing adequate information to the actual ability to provide an ongoing supervisory arrangement that is acceptable to all the parties.

For this to work, however, the supervisory cultures of the home and host countries need to be sufficiently similar. As Kane (2005) points out, Australia's and New Zealand's approaches to supervision differ considerably. New Zealand has a disclosure regime with direct responsibility for bank directors and stiff penalties for non-compliance, while Australia has a traditional intrusive regime. A joint regime would not be possible unless one or other partner changed its regime. In the European environment, the convergence of practices is much greater in monitoring, so operating a joint or 'college' system could work.

The CEBS approach envisages a 'case-by-case' arrangement that takes into account the risks and burden on the institution. The idea is that the cooperation should reflect the supervised institution's relative importance in the various host markets.

What makes this seem most likely is the 'Basel 2 committees' that have already been formed among the supervisors of each major enterprise to sort out the single approach to risk management that will be applied to each banking group. They have to reach a decision, although it will be up to the lead supervisor if the committee as a whole cannot agree.[15] This is heavily emphasised in the CEBS approach to the problem (CEBS, 2006). Whether this will answer many of the perceived problems will depend to some extent on what is achieved in practice. It envisages a 'case-by-case' approach that takes into account the risks and burden on the institution. The idea is that the cooperation should reflect the supervised institution's relative importance in the various host markets. The consolidating supervisor needs to consider the risks from the structure of the institution and correlated risks in the various host locations. This entails developing a 'common understanding' of how the entity should be handled, which should be codified in specific written agreements, such as

[15] Basel 2 (and Solvency 2) both require greater co-operation among supervisors and introduce much wider scope for discretion by moving from simpler to more complex rule systems. It is not clear what the outcome will be. The industry fears more variety but the likelihood is more variety between supervised institutions than more variety of supervisory rules within any given institution.

Memoranda of Understanding. The running of this set-up should be transparent to the supervised institution and the consolidating supervisor should be the primary point of contact with the group – local contacts with host supervisors are also expected to continue.

The 'college' approach has the advantage that it is easier for all of the supervisors to feel they are jointly responsible, because they are all part of the supervisory team. That may not be so easy to achieve in a hierarchical arrangement. Nevertheless, despite the existence of the team, the home country will still be the leader. How they will manage to run the joint arrangement is more difficult to establish. Each country's interest in the joint enterprise could be thought to be proportional to its share of the group's activities or assets. (Its interest in what should be done in any particular situation will of course be far more related to the potential impact on the market for which it is responsible.) However, there is a clear danger that joint responsibility could result in nobody really taking responsibility. It is difficult to set out how to avoid such an abdication but it clearly can be avoided in practice, as indicated, for example, by cabinet government.

The 'college' approach has the advantage that it is easier for all of the supervisors to feel they are jointly responsible, because they are all part of the supervisory team.

The CEBS (2006) guidelines provide quite detailed lists of the areas that need to be addressed, first in assessing the cross-border issues that supervisors need to cope with, second in setting out how they will cover these in their supervisory arrangements in the light of an assessment of the risks that seem to be involved with the institution. Once applied, these results need to be evaluated and a further interaction with the institution itself will be necessary to establish the ongoing approach to supervision of the group. Because the CRD implementing Basel 2 is a new process, it provides a very specific opportunity to evaluate how each financial institution should be supervised, whether cross-border or not.

The collegial approach can be interpreted as an extension of the current home-host arrangement but it is not quite clear where this falls between Schoenmaker and Oosterloo's categories A and C in Table 1. Its governance is not clear, a point we return to in the next section. The home-host arrangement works because each of the parties has a defined set of tasks they undertake on their own, subject to the prior multilateral or bilateral agreement of the group of supervisors, and the consolidating supervisor assembles the picture for the enterprise as a whole. The home country, acting as lead supervisor and operating the system after discussion with the host supervisors, also has a clear format. The collegial approach would effectively be a scheme somewhat more akin to the set up of the Eurosystem, where the Governing Council (the college) is the decision-making body and the ECB and the national central banks are the executive bodies. (Schoenmaker (2005) refers to a European System of

The collegial approach would effectively be a scheme somewhat more akin to the set up of the Eurosystem.

Financial Supervisors and a European Financial Agency as the equivalent concepts.) The ECB has competence in only a number of defined areas and acts in many as the co-ordinator and consolidator of the activities of others – Eurosystem forecasts are a simple case in point. For ongoing supervision, where detailed control and rapid decision-making are not normally required, this sort of arrangement could well be effective, since all the parties have an interest in making it work. The stronger the role of the lead supervisor, the more carefully spelt out the agency relationship has to be.

Schoenmaker and Oosterloo question the efficiency of the home-host approach, arguing that it may lead to duplication. In a sense, the same question could be asked of the US system, where there are multiple supervisors. The key questions remain: how great is this particular cost in practice, and does having different supervisors with different mandates crawling over the same information from different perspectives not in fact lead to better rather than worse supervision? It is difficult to answer this in advance.

The EFR concept is to have the same cross-border supervisory arrangement, whether the enterprise is operated through branches or subsidiaries.

It is also a little difficult to sort out whether this collegial approach would meet the industry's concerns, at least as expressed in EFR (2004, p.6), which uses all the terms – 'college', 'lead' and 'consolidating' – as if they were part of the same scheme. The EFR concept is to have the same cross-border supervisory arrangement, whether the enterprise is operated through branches or subsidiaries. The home (lead) supervisor would:

- be the sole point of contact for supervisory issues on prudential matters, whether relating to the group as a whole or to its parts
- decide on the reporting schemes
- validate and authorise internal models
- decide about Pillar 2 issues under Basel 2 and Solvency 2
- decide on capital adequacy on a top-down basis (not bottom up)
- decide on rules for liquidity and its allocation across the group (treasury management)
- organise site inspections which may be undertaken by or with host supervisors
- approve cross-border functions within the group.

The EFR admits that this may be too difficult for a conglomerate and that there may have to be separate lead supervisors for a group's banking, insurance, investment and other functions, subject to an overall group supervisor.[16] It also notes that there are problems when subsidiaries are

[16] Others, such as Di Giorgio and Di Noia (2003), argue that it is important to have a unitary view of supervision and not divide it according to functions.

not wholly owned and where links are required with supervisors outside the EU/EEA, on either a home or a host basis.[17]

What the EFR (2004) paper does is separate the roles of the 'college' in different circumstances. In normal circumstances the role is described as 'advisory', while in a crisis the college would become the management team. They suggest that any deep differences of opinion among the supervisors could be referred to CEBS or other relevant EU Level 3 committees. This is a somewhat different arrangement from what I have outlined above. There a team approach would work for ongoing supervision but crisis management would need to be centred on someone who can act firmly and rapidly on the basis of a predetermined mandate from the various countries involved, with only limited need for recourse to the principals at the height of the crisis. Resort to CEBS would presumably take the form of identifying issues where more detailed agreement is necessary at a European level, rather than implying it should play some sort of judicial role. This would therefore be a form of feedback to the committees on problems that arise from parts of the supervisory arrangements that are not sufficiently convergent for national differences to coexist harmoniously. Members of CEBS or another specific body could of course act as 'mediators' in disputes, enabling the parties to come to an agreement more readily, but without any power of enforcement either over the agreement itself or its implementation.[18]

If the lead (home) supervisor operates under a 'European' mandate, home and host supervisors would still do much of the work.

In concluding this section, it is worth adding a couple of remarks on the European level approach to the problem. Schoenmaker and Oosterloo (2006) argue that the lead (home) supervisor needs to operate under a 'European' mandate, i.e. to have proper regard for the interests of all the parties. The European level supervisor for these cross-border groups with potential systemic implications would do the same. While this would involve creating a more elaborate institution in order to play the lead and consolidating role, it would be the home and host supervisors who would be doing much of the work, with the European level supervisor fulfilling a role, like that of the Federal Reserve, as the umbrella supervisor. It is therefore not clear that this need suffer from the remoteness from the supervised and the markets in which they operate that Schoenmaker and Oosterloo fear, as shown in the last column of Table 1. The European level group does not need to sit in offices in a single European capital. It

[17] The European Financial Services Roundtable is of course an interest group, representing the views of the larger institutions in Europe. Hence while they may be concerned to ensure that cross-border institutions are not disadvantaged relative to purely national ones and indeed can exploit all the advantages of consolidating operations, they do not have any obligation to consider any unequal advantages large players gain over small (Stern and Feldman, 2004).

[18] CESR set up a Mediation Task Force that produced a consultation paper, 'CESR Mediation Mechanism', in September 2005; this discusses the sorts of matter that might be handled and the structures that could be used to handle them.

could easily be relatively dispersed, so that each unit is closer to those it is supervising.

If, as suggested in Mayes and Liuksila (2003), the European level only focuses on crisis management, it can be a much smaller organisation that is only enlarged when a crisis erupts, drawing on the national supervisors involved. That also considerably reduces the need to focus on the resolution of disputes.

Srejber and Noréus (2005) make the telling point that many of the suggestions for national linkages and lead supervisors are means of getting an outcome similar to that which might be achieved with a Europe-level institution – so why not just create one?

A HARD-LAW APPROACH?

If the current home-host relationship is to be replaced by a lead supervisor model which includes subsidiaries, this too will require European level legislation, at least to the extent of a directive.

If a European level institution is to be set up, then clearly it will require a European level agreement. If the current home-host relationship is to be replaced by a lead supervisor model which includes subsidiaries, this too will require European level legislation, at least to the extent of a directive. It will clearly require national legislation to permit the appropriate delegation of powers to the lead authority and indeed in the opposite direction for the effective supervision of large branch operations in other countries.

Currently, however, most supervisory co-operation is done through soft law, using Memoranda of Understanding. But to what extent can such soft law cover the effective operation of these joint arrangements? Clearly, forming a college of supervisors for individual institutions and agreeing on the sharing of *information* with a common database can follow that route, although changing the confidentiality requirements may well require suitable national legislation to permit other members of the college to have full access to the information on the same basis as domestic supervisors. Similarly, simple agreements are possible for the delegation of tasks among hosts and home supervisors – delegating responsibility is, however, a much deeper issue.

It seems unlikely that credible power could be procured for the lead supervisor to act on issues that affect the financial stability of other member states without some clear mechanism for resolving disputes and obtaining restitution.

What seems much more unlikely is that credible *power* could be procured for the lead supervisor to act on issues that affect the financial stability of other member states without some clear mechanism for resolving disputes and obtaining restitution. So this is likely to involve more than an MoU. While supervisors may be able to agree on the standards to be enforced through soft-law arrangements, as supplements to the Lamfalussy process, their actual enforcement and the imposition of penalties through SEIR and PCA would involve very considerable harmonisation of legislation and it is not clear what could be done if the legislation were not fully implemented. Holthausen and Rønde (2004) doubt whether supervisors will reach an agreement under soft law that results in them sharing the difficult information. They assume there will be a 'cheap talk equilibrium' where supervisors only disclose what is in their (national) interests, despite what is agreed in the MoU.

However, fully effective PCA and resolution in particular require far more comprehensive changes in banking legislation and insolvency law, taking them at least as far as the Swiss reforms (Hüpkes, 2003). The lead authority needs to be able to intervene and ultimately take over the running of a noncompliant systemic institution, particularly if it becomes so undercapitalised that its solvency is threatened and public confidence in it is liable to evaporate. The terms for doing this would need to be set out explicitly in a form equivalent perhaps to FDICIA. Furthermore it would need to be clear how burden-sharing in the event of losses would be arranged and how it would be met. These are major changes. There is a danger that the member states would be tempted to agree the more straightforward items, particularly those that can be covered by soft-law processes, and put off dealing with the tougher issues that relate to contingent events which are hopefully very unlikely to occur. That route would probably have three consequences. First, there is the moral hazard from knowing that the countries do not have the means to step in early or take over the institution to head off a crisis. Second, the lack of prior processes for swift action greatly increases the chances of a crisis in the event of a difficulty and hence the likelihood of the very financial instability that it was hoped could be avoided. Third, it makes it almost certain that public money will have to be used, certainly in the form of guarantees, and possibly also the use of deposit insurance funds.

However, fully effective PCA and resolution in particular require far more comprehensive changes in banking legislation and insolvency law.

In any case, changes in the structure of deposit insurance are likely to be necessary to achieve a better match between the constituency from which depositors are being drawn and the constituency that is providing the insurance. This is particularly important if branches in other countries (and deposits with them) are to become a significant proportion of the exposure of a particular deposit insurance fund. While some of that can be achieved by reinsurance, a change in the deposit insurance directive is more likely to be required. As suggested earlier, the way forward with this is perhaps to take deposit insurance to the European level earlier than other aspects of supervisory/safety-net co-ordination. This might be done in the form of a European Deposit Insurance Corporation (EDIC). However, such an organisation covers primarily the failure (and prior co-

In any case, changes in the structure of deposit insurance are likely to be necessary to achieve a better match between the constituency from which depositors are being drawn and the constituency that is providing the insurance.

rective action) of non-systemic institutions that run across borders.[19] A wider framework is likely to be needed for the systemic cases, as in the United States.

Specifying any of these contracts will be inherently more difficult than in the US, as systemic issues in one country need to be balanced against non-systemic issues in others.

Specifying any of these contracts will be inherently more difficult than in the US, as systemic issues in one country need to be balanced against non-systemic issues in others. Clearly, as in FDICIA, formulating an ex ante agreement would be facilitated by having a largely rule based approach, requiring early action, minimising costs with respect to the insurance fund or some other straightforward criterion, and having no access to public funds, except through an extreme procedure. Problems differ and it is better not to have to specify actions closely. While individuals and corporates that are harmed need a legal route of redress, only an EU level body, such as the ECJ, will offer the member states any redress from negligence or inequity in the treatment by another country's supervisors or indeed by an EU level body.

Taken together, this implies that in the longer run the appropriate way to go is likely to be a version of Schoenmaker and Oosterloo's option D.

Taken together, therefore, this implies that in the longer run the appropriate way to go is likely to be a version of Schoenmaker and Oosterloo's option D. In the meantime, however, it is necessary to resort to a solution that falls under their option C. A leader is needed but the interests of all authorities concerned also need to be taken into account in a manner they find satisfactory at the time and in prospect.

Turning one's back on the game

A workable alternative is to accept that divisions actually offer the best way forward, at least in the short run, even if closer integration is the objective in the longer run.

Instead of trying to find some co-operative arrangement that will function adequately, a workable alternative is to accept that divisions actually offer the best way forward, at least in the short run, even if closer integration is the objective in the longer run. This is the current approach in Australia and New Zealand and it is shown as option E in Table 1. In this approach, the host country can insist that the financial institution's corporate structure and 'outsourcing' policy enable the host country to intervene rapidly in the event of a failure or unacceptably low capitalisation and have an

[19] There are many ways an EDIC could operate, not just simply by having a European level fund. It could be a means of organising the funds of the existing national institutions. If a bank operates through branches in host countries, it can become very large compared to the depositor base in the home country, with a corresponding gain in the host countries, where only a limited proportion of depositors may be domestically insured. Existing national choices of the coverage of insurance can be respected. The main point is the requirement to intervene early and minimise losses with respect to the different interests involved under previously agreed rules, thereby avoiding a time-consuming debate during which possible solutions unravel.

entity within their jurisdiction that can be run on an independent basis before the end of a value day (RBNZ, 2006).[20]

These are strong requirements that would prevent banks from exploiting many of the synergies they hope to achieve by merging operations in different markets. I shall not explore it here because it undermines the whole philosophy of trying to have a single market and make it work. It is considered in more detail in Mayes (2006). However, this approach does have five major advantages that need to be borne in mind in designing any European arrangement:

– it focuses on the practical needs for action and the legal ability to act, not on the nominal structure of branches or subsidiaries
– it focuses on the ability to have a rapid response and on the core functions that need to be maintained without a break in operations
– it focuses on required outcomes, not processes or structures
– it distinguishes between systemic and non-systemic cases, allowing much less onerous conditions in the second case, with the supervisor deciding which category applies
– it specifies the objective, in terms of maintaining financial stability and avoiding 'significant damage to the financial system'.

To exercise these powers, the host authority has to be able to control entry (Mayes et al., 2001), which is not the case in the EU/EEA.

Nevertheless, without a satisfactory solution to the current dilemma in the EU/EEA, the authorities will be inclined to do what they can to preserve economic nationalism in the ownership, structure and control of their banking system so as to protect their financial stability. Indeed, this has already been observed in Poland, where there has been concern that bringing Bank Pekao and BPH under the same foreign ownership (Unicredito) could create an unwelcome systemic risk.

Without a satisfactory solution to the current dilemma in the EU/EEA, the authorities will be inclined to do what they can to preserve economic nationalism in the ownership, structure and control of their banking system so as to protect their financial stability.

Conclusions and issues for discussion

In drawing out the conclusions for discussion, when assessing the problems of cross-border supervision in the EU/EEA it is helpful to divide the institutions to be supervised into three categories. Those with insignificant cross-border activity, those with significant cross-border activity but not

[20] This is set out as the 'legal and practical ability' to ensure that in any event the following can be assured:
– meeting the clearing and settlement obligations on that day;
– the bank's risk positions can be identified on that day and monitored and managed on subsequent days;
– the bank's customers can have access to payment facilities on the following and subsequent days.
A local Board needs to be responsible and accountable for the actions of the entity in the host country.

such as to pose any potential systemic threat to the authorities concerned, and those where at least one authority has concerns that if some or all of the institution's activities were to come to a disorderly halt, that would have an unacceptable impact on financial stability.

1. Differences across countries in supervisory arrangements among the first group may offer competitive advantages (Granlund, 2003) but, given the degree of supervisory convergence being encouraged by CEBS and the level of competition emerging in European markets across borders, this is not seen as particularly important. Other cross-border concerns for this group of institutions, which is numerically large but much smaller in terms of its share of activity, are not significant, except as regards the treatment of mergers, acquisitions and other restrictions on entry. The European Shadow Financial Regulatory Committee has suggested that an 'observatory' or European Banking Oversight Committee be set up to look at issues where national discretion may have been used to the detriment of cross-border activity. This could be widened to Financial Oversight. This suggestion has not been widely considered since it was made in 1998, which may say more about power in European decision-making than the inherent quality of the proposal.
2. The preparations for the implementation of Basel 2 under the Capital Requirements Directive provide a fortunately timed opportunity for supervisors to assess the supervisory needs of cross-border institutions and in particular to determine whether they pose systemic issues to any supervisors involved and hence should belong to the third group. Many of the improvements referred to below can be addressed through this review process but it is essential to apply it to the whole institution, not just the narrowly defined banking operations.
3. The second group of institutions can be dealt with primarily through improvements to the current home-host approach to supervision that go beyond the guidelines proposed by CEBS (2006). These include:
   – an enhanced role for consolidation of supervision and the reduction in the variety of supervisory methods being applied to a cross-border institution. Although the legal form of institutions operating across borders, whether as subsidiaries or branches, is important, the trend towards a concentration of key activities within financial groups raises a particular concern that risks are managed across the group as a whole, not simply by aggregation of the parts. This implies an important role for the home country authority that acts as the lead or consolidating supervisor. Second, the number of regulators involved poses a potential burden on cross-border firms

that inhibits competition. Taken together, these two imply a closer relationship between home and host supervisors than is sometimes practised at present.[21] Views vary on how this should be applied but two key characteristics emerge:

- an enhanced role for the home country supervisor;
- a closer relationship among supervisors, which could be described as collegial

– an improved exchange of *information*, to be achieved by creating a common database on which all members of the college can draw

– treatment of on-site inspection as a collegial issue.

4. The basis for relationships among supervisors needs to be clear and justiciable. It is not clear that Memoranda of Understanding are sufficient for describing the principal-agent relationships involved. In some cases, simple agency arrangements may be the way to proceed.
5. While host (and home) supervisors can be convinced that ongoing supervision of the institution as a whole is being conducted adequately through a closer working relationship and the common information database, the treatment of what to do when institutions get into difficulty or supervisors are concerned needs to be developed. This should take a form similar to that in the United States, where there is a clear programme of Structured Early Intervention and Resolution, in particular a programme of Prompt Corrective Action.
6. In the United States, moreover, responsibility for ensuring that SEIR is applied is assigned to a specific agency, the FDIC. There is a case for setting up a similar organisation in the EU, a European Deposit Insurance Corporation that would fill this gap, and simultaneously correct some of the problems that are being experienced with deposit insurance as a result of the home-host structure.
7. The third group, systemically important institutions, poses much greater problems because the interests of the countries involved are not necessarily aligned and the losses imposed could be significant. What is needed here is not so much a different approach to supervision as a different approach to the resolution of problem institutions. While the EDIC described above could have the objective of minimising its losses in handling problems, in systemic cases there are specific national concerns that preclude a simplistic minimand.
8. The key question remaining is whether there should be a European level agency to perform such resolutions or whether the home country can provide this under a contract that enables other countries to

[21] Even though Nordea has not yet changed its legal structure, the supervisors have already had to co-operate in a detailed manner with, inter alia, joint inspections, as effectively the group's risk management needs are largely the same even in its current form.

obtain restitution for inadequate performance of the task. If this system of agreed rules for supervision, corrective action and resolution that takes into account the needs of small host countries can be put in place in other ways than by explicit intergovernmental agreement, then it might be possible to agree these arrangements case by case for the limited number of cross-border institutions. Outside groupings like the Nordic area, with its highly convergent systems and a history of working well together, there must be considerable doubts about the credibility of this ex ante commitment, which suggests that an EU level will be needed. In the meantime, any case by case solutions will need to be structured so that they can evolve into the EU level if and when that exists.

9. Host country control as practised in New Zealand and the US will work but at a cost to the institutions themselves and to the ability to integrate operations. It is an attractive option for independent small countries but does not reflect the purpose of European integration.
10. There is a temptation to avoid the hard issues and concentrate on a practical solution for supervisors to work together on the routine supervision of existing institutions. While this can indeed work until a problem emerges, it creates both an illusion of future financial stability and a moral hazard. Without workable means of co-ordination, institutions and lenders will expect that the authorities will be forced into a bailout and risks will be priced accordingly. Where institutions are large compared to the home country, this ability to bail out may be limited. Where host countries cannot compel a rescue, they may be plunged into just the financial crisis the system is intended to avoid.

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