The future relationship between financial stability and supervision in the EU

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Financial stability, supervision and regulatory design have traditionally been the responsibility of national central banks, supervisory authorities and governments. These national regimes are now beginning to be challenged by the ongoing internationalisation – globally and in the EU – of financial markets, infrastructures and institutions. One important component of this change is that banks and other financial companies work more along global business lines and less along national borders. Hence, governments, supervisors and central banks will have to adapt to a new reality. To be able to cope with this change and find new solutions it is necessary for the authorities involved to focus on their core tasks and to a certain degree invent new ways to perform those tasks.

This paper is structured in the following way. First, there is a brief discussion on the relationship between supervision and financial stability on a national basis, with the institutional set-up in Sweden as a case in point. Then follows a description of how the cross-border integration now taking place in the EU:s financial sector is challenging the ways in which supervisors and central banks traditionally have been working. The paper concludes with a discussion on some of the proposed alternatives for how EU policy-makers can respond to these challenges.

The relationship on a national basis: the Swedish case

Prior to the banking crisis in the early 1990s, the cooperation between the Riksbank and the Swedish Financial Supervisory Authority (FSA), then the Banking Inspection, was limited to high-level contacts. In their day-to-day activities, however, the two authorities worked in different silos – the

Riksbank with monetary and exchange rate policy and the FSA with regulating and supervising financial institutions. The crisis made it very clear to the Swedish authorities that there is a strong link between the soundness of financial institutions and macro financial stability, and hence a need for close cooperation between the FSA and the central bank.

The crisis in the early 1990s clarified the strong link between the health of individual banks and financial stability.

This economic link is mirrored by a parallel link spanning at least three aspects of regulatory involvement in the financial sector – crisis prevention, crisis management and crisis resolution. In Sweden, these aspects of regulatory involvement are shared between the supervisor, the central bank and the Ministry of Finance.

In crisis prevention, the supervisor has the tools for regulating and supervising the institutions, while the central bank might play a supporting role through monitoring the stability of the system and the links to the real economy. In crisis management, the supervisor lacks the financial resources to back any intervention, while the central bank has the power to act as a lender of last resort. In other words, the likelihood that the central bank will have to provide liquidity support to a financial institution is partly determined by the quality of supervision. At the same time, the central bank may very well need the supervisor's analytical support or information to be able to decide on whether, and how, to intervene. Finally, in crisis resolution, even if the Ministry of Finance takes the lead, it is likely to rely extensively on the supervisor and the central bank for advice and action.

The supervisor has the regulatory tools to influence the institutions, while the central bank can act as a lender of last resort.

Since there is a link between the soundness of institutions and financial stability, then supervisors must be interested in crisis management and resolution and central banks must be interested in certain aspects of supervision.

In the last decade, at least in Sweden, the macro and micro perspective have grown gradually closer. Indeed, the Swedish FSA now has an explicit interest in the stability of the system, while the Riksbank has taken a greater interest in the stability of single institutions, if they are judged as systemically relevant. There are regular contacts to share information and assessments and to coordinate policy.

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The times they are a-changin'

This seemingly happy relationship could have been the end of our story but recently there have appeared challenges to this set-up. All over the globe, the financial markets are becoming more integrated and financial institutions as well as financial infrastructure companies are consolidating domestically as well as cross-border. The challenge touches all the aspects of regulatory involvement – crisis prevention, crisis management and crisis resolution.

CROSS-BORDER INTEGRATION OF FINANCIAL MARKETS ...

In the EU, the process of cross-border integration has been actively promoted by the creation of the euro and the ongoing harmonisation of regulation and supervision – in recent years epitomised by the Financial Services Action Plan (FSAP). Admittedly, financial markets integration in the EU has so far been a mixed bag.

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Until now, integration has mostly taken place in wholesale markets, such as the money market and the bond markets. Many investment banking segments such as capital raising and mergers and acquisitions (M&A) for large corporations are also dominated by global giants. In contrast, retail financial services are still to a very large extent controlled by domestic players, at least in the old member states.

... AND INSTITUTIONS ...

Integration of ownership will result in integration of lending/funding, organisation, products and services.

Probably cross-border integration is only just beginning. Banking integration will probably not primarily take place through direct cross-border provision of services but through cross-border bank M&A. Integration of ownership will result in integration of lending/funding, organisation, products and services.

According to a study by the European Central Bank (ECB), 43 banks and banking groups are active in more than three EU countries.[1] Only some years ago, crossborder banking M&A in the EU was only taking place between small countries or vis-à-vis the new member states – Austrian and Swedish banks' expansion into some central European and Baltic countries are well-known examples of this phenomenon. Now this is changing. Today major banks from large countries are all trying to build European platforms. For instance, Spanish Grupo Santander now owns the fifth largest UK bank, and Barclays of the UK owns the sixth largest private sector bank in Spain. And this year, the medium sized Italian bank Antonveneta was acquired by the Dutch bank ABN Amro, while the largest Italian bank, UniCredito, acquired the third largest German Bank, HVB.

1 Banking Supervision Committee (2004), "Cross-border banking and its possible policy implications", December.

… IS GOOD NEWS FOR THE ECONOMY BUT CREATES CHALLENGES FOR SUPERVISORS AND CENTRAL BANKS

The Riksbank welcomes this development. The bank believes financial market integration is strongly positive for economic efficiency and hence for growth and welfare in the EU. But at the same time, the bank admits that integration presents some complex and multifaceted challenges to the authorities.

The Riksbank believes financial market integration is positive for economic efficiency.

At the outset, integration is obviously hindered by differences in language, business culture and national laws and regulations. But once it happens, integration tends to follow the logic of business, and not the "logic" of country borders or national law. For instance, for financial groups which are expanding cross-border a part of the synergies is derived from centralising functions. Hence, the group's credit risk model might be developed in the parent bank, while the group's liquidity is managed through a foreign subsidiary, and the group's derivatives trading is done in yet another subsidiary. That is why integration gives rise to a structure that often seems to be in conflict with the present regulatory structure. But the problem is not integration – the problem is that the regulatory framework is not designed for a single market for financial services.

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For example, in the Nordic and Baltic countries – excluding Iceland – there are six banking groups with significant cross-border activities. Each one of these cross-border groups has regulatory contacts with seven supervisors and eight central banks.[2] It is commonplace to note that Western Europe is over-banked. It would not be outrageous to say that it is also over-crowded with regulatory authorities.

Our conclusion is that the national governments and authorities in the EU must solve the issues that integration gives rise to, rather than preventing integration. This might sound very obvious, but some governments and authorities still only pay lip service to the idea of the single market. Or they love the idea of the single market as long as it means that their own banks survive as national champions and are able to expand abroad.

The national governments and authorities in the EU must solve the issues that integration gives rise to, rather than preventing integration.

The most important and difficult question that policymakers will have to answer is how to shape and balance the relationship between authorities – central banks and supervisors – in different countries in the EU. It goes without saying that since laws and regulations and the division of responsibilities between authorities are ultimately decided by the govern-

[2] The Bank of Lithuania also has supervisory responsibility.

ments of the member states, the challenge of integration inevitably also concerns finance ministries.

Back to basics

What will be the roles of national supervisors and central banks in an integrated EU financial market?

What will be the roles of national supervisors and central banks in an integrated EU financial market? If central banks and supervisors have not done it before, cross-border integration will force them to think hard about their responsibilities, mandates and tools.

In order to do this, they will have to go back to the beginning and find their "raison d'être". What is special about the financial system and why are authorities regulating, supervising and monitoring financial markets and institutions? Who or what are supervisors and central banks protecting and which tools do they need?

Whether authorities want to defend the status quo or reform the regulatory framework, they will need to prove their case to politicians as well as to each other. By itself, this might very well improve the way supervisors and central banks work. One may call this a positive external effect of integration.

Cross-border integration forces national central banks and supervisors to find their "raison d'être".

There are many issues at the table, but in the context of this paper we would like to divide them into two categories.

The first category includes the issues of what regulations should be imposed on institutions and markets in the EU. How can laws and regulations be designed flexible enough to fit all countries reasonably well, while strict and "harmonised" enough to support a single market?

The second category is essentially about the relationship between supervisors and central banks in different countries – the division of labour, power and responsibilities. This category of issues has come to be broadly referred to as the home-host issues. The next section gives a short comment on the regulatory issues, while the rest of the paper is devoted to the home-host issues.

REGULATION

All regulation involves costs; it should be used only when there is a clear case of market failure.

Regulation at EU-level first of all faces the same basic trade-off as at country level. The Riksbank's view is that since almost all regulation involves costs – in terms of lower efficiency and growth – it should be a last resort and used only when there is a clear case of market failure. Some regulation is surely needed to ensure a stable and sound financial system and necessary consumer protection. But too much or too strict regulation will give rise to new costs that are higher than the original costs that regulation initially aimed to address.

Regulation at EU-level also faces another trade-off that is not present at national level – that between the value of a *level playing field* and the cost of an overly detailed or inadequate regulation. A completely level playing field presupposes detailed rules that are applied in the same way in every market. But overly detailed rules at EU-level risk being inadequate at national level since national markets often differ widely. This could give rise to costly overregulation hampering financial development or driving financial institutions to settle elsewhere. Hence, it might be wise to leave some degree of freedom to the member countries. Historically, institutional competition has proved to be very positive for development in the long run.

The starting point for EU rules should be the lowest common denominator.

At the same time, EU directives (as most international rules) tend to leave plenty of room for *national discretions*, effectively reducing the value of the convergence/harmonisation that was probably the motivation for the directive in the first place. There is the risk of ending up with the worst of two worlds – very detailed rules on the EU level and numerous discretions at national level. This makes the rules opaque and their implementation difficult to predict for the private sector. The starting point for EU rules should be the lowest common denominator. Today instead, it often seems like the starting point is the sum of all member states' national rules.

Representatives of national authorities may all be convinced that their national discretions are worth fighting for and take pride when they are included in the final drafts. Perhaps everybody should ask themselves more often whether the discretions are motivated by a fundamental need or just deep-rooted tradition or, even worse, the unconscious caving in to special interest groups. Why not take this opportunity for change and think new instead of designing EU regulation on the basis of existing, often imperfect, national regulation?

One of the main objectives of the CEBS is to promote convergence of supervisory rules and practices.

The need for a *common rule book* for large cross-border banking groups is often raised by the industry. In principle, one can be sympathetic to this wish. If a common rule book means "just" common rules the developments are certainly going in that direction. One of the main objectives of the Committee of European Banking Supervisors (CEBS) is to promote convergence of supervisory rules and practices. However, in the sense of common or centralised decision making by authorities, it is probably still far away from being realised. As long as the implementation and interpretation of directives and rules is done on a national level it will take time before there is a common rule book.

Still, the aim should be to eliminate or reduce these differences as much as possible. Any remaining differences in supervisory practices between countries should be clearly disclosed in order to improve the pre-

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dictability of the EU regulatory system – which is another area where the CEBS is doing important work. Another practical example of how to reduce the regulatory burden would be for countries to agree on a common and centralised reporting standard for large cross-border groups.

THE HOME-HOST RELATIONSHIP ...

The home-host relationship is about how to divide tasks, powers and responsibility between different countries.

The home-host relationship is the underlying theme running through a number of issues in the regulatory debate. Broadly speaking, the home-host relationship is about how to divide tasks, powers and responsibility between different countries when it comes to supervising, monitoring and, in the worst case, sorting out financial institutions in distress.

Formally, the home-host relationship only refers to the division of responsibility between supervisors, which is currently based on the principle of home country control. The home country is the country where the bank is licensed. For a bank, this means that the home country is responsible for supervising the bank and its foreign branches. The home country's deposit insurance also covers its banks' foreign branches. In the case of a group, it means that the home country is also responsible for supervising the entire group on a consolidated basis, while the host countries are responsible for their respective subsidiary banks and deposits. This autumn, the CEBS is finalising the so-called home-host paper giving guidance on how the home-host supervisory relationship should be arranged given existing EU legislation.

Even if there are no legally-binding rules regarding the relationship between countries in crisis management or crisis resolution, these aspects of regulatory involvement have borrowed the terminology of the supervisory home-host concept. For example, when discussing lender of last resort in crisis management and burden sharing in crisis resolution, references are made to home and host central banks and finance ministries, respectively. This is natural, since legally the financial liabilities for a group are ultimately carried by the parent bank. Of course, a parent can choose to let a subsidiary fail, but it will then have to bear the capital loss. Subsequently, in practice, the ultimate public responsibility over a group rests with the home country.

... COMES UNDER STRAIN ...

The home country principle was not designed for a fully integrated market.

At first glance, the home country principle seems very neat. But a closer look reveals that this set-up was not designed for a fully integrated market. Essentially, there is a gap between, on the one hand, legal powers and mandates and, on the other hand, de facto abilities and responsibilities. Home countries are given powers over branches and subsidiaries but might be unable or unwilling to use them, while host countries are losing powers that they have been willing to use. This gap becomes a problem once there is a banking group or bank that is systemically relevant in a host country (see table 1). Even if there are not so many of these cases yet, the number will most certainly increase. The potential conflicts of interest and coordination problems are of many kinds. Below are some examples:

TABLE 1. THE HOME-HOST RELATIONSHIP (FOR A BANK OR BANK GROUP)

	Systemic relevance in HOST country	
Systemic relevance in HOME country	Significant	Non-significant
Significant	Potential conflicts of interest and coordination problems	Not a big problem
Non-significant	Potential conflicts of interest and coordination problems	Not a big problem

… WHEN BRANCHES AND SUBSIDIARIES BECOME SYSTEMICALLY RELEVANT

Suppose there is a banking group of roughly equal systemic relevance in the home country and the host country. The home country supervisor is the consolidating supervisor and coordinates the activities vis-à-vis the group. If cooperation works well, the host supervisor will receive information from the home supervisor. But in the event of a crisis in the banking group, all authorities have a clear mandate to protect only their depositors and systems. One can easily imagine a situation where the group has surplus capital in one of its parts, extra liquidity in another and the cause of the problem is in a third part. The lack of coordination might very well result in a poorer (more costly) outcome for all involved.

If the presence in the host country is a branch and not a subsidiary, the host supervisor has only limited means of obtaining information about – or taking actions against – the bank. In the event of a crisis it can only hope that the home country will take the host country's situation into account when managing the crisis. The home country, on the other hand, faces a situation where it could be necessary for its central bank to provide emergency liquidity assistance (ELA) to support a bank which has a large part of its activities in other countries. Should the bank need to be reconstructed it would be the home country's tax payers that would have to foot the bill – either by supplying the necessary capital to the bank or by supporting the deposit guarantee system with the funds needed to pay out insurance to the bank's depositors.

In the event of a crisis host authorities can only hope that home authorities will take its situation into account.

The imbalance between home and host countries may be further deepened by differences in size between countries.

The imbalance between home and host countries may be further deepened by differences in size between the two countries. One case will be that of a big home country and a smaller host country. The banking group's exposure to the host country is then probably relatively small on a consolidated basis. This results in the home country authorities spending relatively limited resources – in terms of staff – on the foreign subsidiary's activities in the host country. If such a banking group runs into problems, the home country authorities will not necessarily view it as systemic, while the host country authorities certainly will do.

How to deal with the home-host asymmetry?

In all these examples host authorities have a legitimate interest in being able to influence supervision, share assessments and have a say in the event of a crisis situation. They have been given the task of protecting the soundness and stability of their financial sector and the general public in the host country will rightly expect their authorities to be able to do this. At the same time, the home authorities should have an interest in sharing resources in crisis prevention and risks and costs in crisis management and resolution with the host countries. In the current setting, however, this is only possible to a very limited extent.

There is a need to share information and …

First, there is a need to share information between the home and the host. This should be the least difficult, but in practice everyone who has tried to share information between authorities knows it can be a complicated and cumbersome process, at least until there is an established routine. Even when there are no confidentiality concerns there are many practical obstacles to overcome. Information sharing is not only about sending data back and forth, but more importantly, it is about explaining information and sharing assessments. If hosts are under the impression that they know a lot less than the home, it will be very difficult to achieve cooperation.

… there is a need to cooperate on actions vis-à-vis the bank or the group.

Second, there is a need to cooperate on actions vis-à-vis the bank or the group and its components. If host authorities cannot influence the process of supervision or crisis management, their trust in and use of the information from the home authorities will be very limited.

So far, cooperation and coordination in crisis situations is dealt with in the EU by various Memoranda of Understanding.

Sharing information and cooperating on regulatory actions may be problematic already in normal times, but is probably much more difficult in a crisis situation when economic risks and costs are clearly visible. So far, cooperation and coordination in crisis situations is dealt with in the EU by various Memoranda of Understanding (MoU). Even if these MoUs are not legally binding, they are valuable documents. They provide a basis from which more operational crisis cooperation agreements can be developed by the countries and authorities that see the need to do so.

But looking at this increasingly complex patchwork of supervisory colleges, central bank networks and MoUs that is now being created, one cannot help wondering whether there are no better alternatives for cross-border cooperation.

Future alternatives to the home-host model

What are, in the medium or long term, the alternative models to the current home-host set-up? In the EU, there is a commitment to create a single market for financial services. But do governments and authorities really believe that the home-host model is the best one in the long run?

After all, several serious alternative models have been suggested. The pros and cons of the three main models are reviewed in an interesting paper by Oosterloo & Schoenmaker.[3]

THREE ALTERNATIVES FOR SUPERVISION

The first alternative is to give the home supervisor the role of lead supervisor.

The first alternative is to give the home supervisor the role of *lead supervisor* with full responsibility for EU operations, branches as well as subsidiaries. This is the proposal from the European Financial Services Round Table (EFR).[4] The lead supervisor would be the single point of contact for reporting and would validate and authorise internal models, approve capital and liquidity allocations and decide about on-site inspections. In short, the lead supervisor would have full supervisory responsibility. The lead supervisor would be complemented with a college of supervisors, which would "serve as a conduit for close information-sharing and interaction amongst supervisors" and ensure that host countries' interests are taken into account. Disagreements between supervisors would "be resolved by means of a mediation mechanism". In a crisis situation, the lead supervisor would coordinate a management team representing the college of supervisors. This team would also have to coordinate with central banks, deposit guarantee schemes and finance ministries. For central banks, the EFR suggests that these would create an arrangement that mirrors that of the lead supervisor, with the home national central bank taking the role as

3 Oosterloo & Schoenmaker (2004), "A lead supervisor model for Europe", *The Financial Regulator*, Vol.9.3, 34–42.

4 See "On the lead supervisor model and the future of financial supervision in the EU", European Financial Services Round Table, June 2005. It should be noted, however, that the EFR points out that the lead supervisor model was "motivated by the need to find a near-term arrangement for financial supervision in the EU". In the long-term, the EFR seems to be in favour of a European System of Financial Supervisors (ESFS) modelled on the European System of Central Banks (ESCB). This long-term model is basically one possible form of "the third alternative" as presented in this paper.

a "lead lender of last resort", although being obliged to consult with the relevant host central banks.

The second alternative is to give the home supervisor the role of lead supervisor with an EU mandate.

The second alternative, which is put forward by Oosterloo & Schoenmaker, is to give the home supervisor the role of *lead supervisor with an EU mandate*. The lead supervisor would basically work as in the EFR model, with the difference that the lead supervisor is given a "European mandate to ensure that the interests of all depositors/countries are taken into account". In this model there is a decision-making agency of European Financial Supervisors at the centre, which is delegating the task of supervision to each respective home supervisor. Hence, there is no need for a college of supervisors or a mediation mechanism. Regarding financial stability and crisis management issues, the home country central bank would also be involved, acting on behalf of the European System of Central Banks (ESCB). Since financial stability and lender of last resort are presently the responsibility of the national central banks, this would also imply a change to the mandate of the ESCB.

The third alternative would be to create a European Supervisor.

The third alternative is both the most obvious and the most radical and would be to create a *European Financial Supervisor*.[5] This simply means having one authority acting with full supervisory powers over branches and subsidiaries of cross-border European banks. The system could be tiered (like in the United States) in the sense that the EU supervisor would only be responsible for banks and banking groups with significant cross-border operations, while purely domestic banks could remain the responsibility of the national supervisors. As is the case with the lead supervisor with an EU mandate, a European Financial Supervisor would imply a parallel centralisation of the responsibility for lender of last resort.

A EUROPEAN FINANCIAL SUPERVISOR

All three alternatives are considerably more far-reaching than what is currently under construction.

All three of these alternatives, even the first one, are considerably more far-reaching than what is currently under construction. The first alternative with a lead supervisor addresses the problem mainly from the cross-border bank's perspective of minimising the regulatory burden. This is important but does not solve the underlying conflicts of interest between the home and the host countries. It seems this alternative would be very dependent on the mediation mechanism, which, in practice, would have to determine the balance between different interests. At the same time, if the mediation mechanism is not backed by EU law it is hard to see why the outcomes of such a mechanism would be accepted by national

[5] This idea has been put forward by, for example, Rolf Breuer, chairman of the supervisory board of Deutsche Bank and president of the Association of German Banks, in his speech "The future of the German banking sector" in February 2005.

authorities. Furthermore, the operational set-up of the mediation mechanism would be crucial. For instance, are decisions supposed to be taken on a consensus basis or will there be a voting procedure? If there is a voting procedure there is the difficult question of how to allocate the votes between countries. Another open question concerns the relationship between the mediation mechanism and other EU institutions. What happens if a party that has been "overruled" in the mediation mechanism chooses to bring their case to the European Commission or the European Court of Justice? In short, it is a model which might work when the weather is fair and no deeper conflicts of interest are to be solved, but would have the same shortcomings as the present framework when faced with stormier weather. And there would still be a need for more or less ad-hoc cross-border cooperation or negotiation at the time of crisis.

The second alternative – the lead supervisor with an EU mandate – seems nice in theory and aims at solving the conflicts of interest by creating a central decision-making body. In practice, however, it could easily become very bureaucratic and inefficient. If a central decision-making body is established anyway, why act through 25 different authorities? Both the first and the second alternatives are half-way compromises trying to please different interests. The third alternative, although radical, is the logical solution. Beyond possible political considerations, there are two main arguments against the idea of a European Financial Supervisor – one relevant and one not very relevant.

To create a European Financial Supervisor is the logical, if radical, solution.

The not very relevant argument is that the supervisor needs proximity to have knowledge about the markets where the institution operates. First, this is already a problem with the home-host model. Second, this is an organisational problem that can be solved. An EU supervisor would certainly employ staff from all EU countries and have local offices in the national financial centres. For instance, for a regional cross-border banking group, the supervisory team would presumably be based in the relevant region, perhaps in the same premises as the national FSA, and would consist of staff from that region.

The relevant argument against an EU supervisor is that supervisory power ultimately needs to be backed by financial muscle. In the present set-up, the financial muscle derives from the national central bank's ability to act as a lender of last resort and the government's ability to raise taxes. The EU lacks such power.

However, this problem is hardly insoluble. For instance, it is conceivable that the EU could build up a deposit insurance fund for cross-border banks supervised by the EU supervisor, which would be able to handle all but the largest banking failures. In fact, such an EU fund would be better diversified than the national funds are today, which all else being equal would enable it to charge lower fees or hold a larger risk-adjusted buffer. In the event of really large banks or several large banks failing, there could be an established system of committed drawing rights, where the EU fund has the right to raise funds through national governments' ability to raise tax. Regarding liquidity support, the ECB would be given the role as lender of last resort.

To convince national governments to commit such guarantees would of course demand very strict and well thought-out rules governing what actions the EU fund should be allowed to take in the case of a bank failure. These rules could be inspired by the US Federal Deposit Insurance Corporation's very strict mandate to always choose the least cost solution. Among other things, this would in some cases mean allowing shareholders as well as uninsured depositors and debt holders to lose their money. Since today, most EU countries lack rules on how to handle large bank failures, it would also be very positive from a contingency planning and moral hazard point of view. With a strong legal framework, the EU would be able to allow investors in even the largest banks to take full financial responsibility.

Concluding remarks

It is hard to see how, in the long run, the EU could avoid establishing an EU financial supervisor.

Tommaso Padoa-Schioppa, the former member of the executive board of the ECB, has remarked that there is no need for a European supervisor if national supervisors can prove that, when needed, they are able to act as one. However, it is hard to see how, in the long run, the EU could avoid establishing an EU financial supervisor. At the moment, supervisors and central banks are spending considerable resources on trying to construct arrangements that will enable them to work and act as one. Why not instead become one, and spend the resources on supervision and monitoring?