OeNB

Oesterreichische Nationalbank

Eurosystem

Workshops

Proceedings of OeNB Workshops

A Constitutional Treaty for an Enlarged Europe: Institutional and Economic Implications for Economic and Monetary Union

November 5, 2004

No. 4

Financial Stability Arrangements in Europe: A Review

Anne-Marie Gulde
Holger C. Wolf[1]

International Monetary Fund and Georgetown University

1. Introduction

> "*Few regard the current institutional structure as fully satisfactory or in a final state. The obscurity surrounding the legal position of the ESCB, the principle of subsidiarity, and the difficulties of agreeing loss sharing amongst separate national (fiscal) authorities all militate towards leaving the onus for supervision and crisis handling at the national (NCB) level. Logical tidiness and the likelihood of increasing externalities (overspills), as financial interpenetration within the EU gathers pace, suggest greater centralization." (Goodhart, 2000, p. 11)*

"May you live in interesting times." Banking regulators and supervisors in the European Union may at times be reminded of this doubled-edged Chinese saying. EU expansion, deepening financial integration, monetary unification among a subset of Member States, the trend towards large-scale cross-border mergers and the substantial changes likely to be wrought by Basle II, supervision II, International Financial Reporting Standards (IFRS), and International Accounting Standards (IAS) all pose important challenges to the traditional nationally based system of supervision.

The gauntlet has been taken up. Though (often separate) national supervisory agencies for banking, insurance and securities markets remain the norm, the

[1] We would like to thank Karin Hrdlicka for very helpful comments. Many thanks also to Eduard Hochreiter, Hans-Helmut Kotz, and participants at the Workshop and at the March 2004 SUERF seminar on *The Future of Regional Insurance Companies* in Graz; as well as to Haizhou Huang, Paul Kupiec, Thordur Olafsson and Jan-Willem Van der Vossen for discussions. Disclaimer: The paper reflects the personal opinion of the authors and not necessarily of the institutions they are affiliated with.

European supervisory system has become substantially internationalized through harmonized minimum standards, extensive information-sharing networks and cooperation; generally following and building upon the guidelines proposed by the Basel Committee and other coordinating bodies.[2]

Yet a host of questions and challenges remain. Looking forward, will the current system of co-ordinated national (sectoral) supervision remain equal to its task as EU-level financial institutions gain in importance? Or do increasing integration and more prevalent cross-border spillovers demand discrete institutional adjustments, in particular the creation of a multi-lateral supervisor? Should any multi-lateral supervisory agency retain the traditional split between *insurance*, *securities* and *banking* or be integrated across financial market areas?

Does the loss of national monetary autonomy for the Eurozone members imply particular urgency for this group? If so, should the supervisory and the monetary policy function be combined in the ECB or split into the central bank and a separate financial supervisory agency? In either case, how should Lender of Last Resort (LOLR) functions and burden sharing arrangements be handled?

These questions have been subject to a lively and sometimes controversial debate involving academics, public officials and bankers. The discussions, dating back to the early 1990s, pit proponents of greater integration and centralization against advocates of a more localized approach. We hope that this paper, which reviews and discusses some of the challenges in the European banking system in greater detail, contributes to the search for a consensus. We begin with a brief presentation of recent trends in cross-border activity in banking and insurance before turning to the challenges and potential solutions in the areas of supervision and crisis management.

2. How Important Are Pan-European and Multi-Sector Financial Institutions?

The importance of institutional reform depends on the degree to which the formerly national financial markets have evolved into a true European financial market with multi-national financial institutions, and, related, on the importance of cross-border spillovers and externalities. A sizable literature explores both the state of integration and possible causes of border effects:[3]

---

[2] The Basel Committee guidelines include the Basel Concordat (1983), The Supervision of Cross-Border Banking (1996), Core Principles for Effective Banking Supervision (1997) and Supervision of Financial Conglomerates (1999). On the insurance side, the International Association of Insurance Supervisors' Core Principles for Insurance Supervision aimed to harmonize standards.

[3] Recent comprehensive studies include Hartmann, Maddaloni and Manganelli (2003), Baele, Ferrando, Hördahl, Krylova and Monnet (2004), Manna (2004) and Reszat (2004).

- Do national banks increasingly take on international business or risk?[4]
- Are prices and returns converging?[5]
- How important are legal and institutional restrictions?[6]

While a full exploration of these issues would take us far beyond our core topic it is worthwhile to highlight some trends brought out by the literature for the specific area of banking. First, cross-border merger and acquisition (M&A) activity in banking remains robust but is smaller than intra-national (M&A)[7]. Only a small fraction of cross-border deals result in integrated structures operating under a single brand name in multiple markets. Second, wholesale banking markets appear to be substantially more integrated than retail markets, which appear to be subject to significant border effects. Beyond the home bias, proximity effects seem to be secondary (Manna, 2004).

Third, EMU does not as yet appear to have led to a marked increase in integration levels or trends; aside from a (pre-adoption) interest rate convergence, in particular visible for government bond yields. Fourth, while multi-sector financial institutions, notably banking-insurance combinations are gaining in prominence, the traditional core sector tends to remain dominant in these institutions. Finally, as a partial exception to these trends, foreign ownership stakes in the new member countries are substantially higher.

Most critical reviews of the evidence correspondingly find European financial markets to remain far from integrated. Philip Hartmann, Angela Maddaloni and Simone Manganelli (2003) conclude that "In the area of retail banking the increased homogeneity of interest rates seems to be driven more by macroeconomic convergence than by market integration. For example, cross-border loans to non-banks have somewhat increased but remain a very small fraction of total lending. This is quite different in wholesale activities, as inter-bank lending jumped up with the introduction of the Euro and banks' cross-border security holdings also expanded considerably. While the strongly domestic bias in the consolidation strategies of European banks has only changed very mildly recently, and while the single European passport to create foreign bank branches seems not to be used very much, it is interesting to report the observation that in the U.S.A, too, cross-state penetration by banks still remains quite limited."[8,9]

---

[4] See Buch (2001), Buch and DeLong (2002), Manna (2004).

[5] See e.g. Danthine, Giavazzi and von Thadden (2000) and Hartmann, Manna and Manzanares (2001).

[6] See Danthine, Giavazzi, Vives and von Thadden (1999).

[7] Dermine (2003). See Berger et al. (1999, 2000, and 2003) and Buch and DeLong (2002) on the economics of bank mergers and consolidation.

[8] Hartmann, Maddaloni and Manganelli (2003).

Looking at the same issue from the banker's perspective, Emilio Botin, Chairman of Grupo Santander, expresses a similarly skeptical view in evaluating promising strategies for European banks: "Another alternative, which is widely discussed these days, is a large cross-border merger, especially between European banks. Some believe, perhaps with an eye on the success of big U.S. mergers, that the movement towards greater integration in the European Union makes such cross-border mergers advisable in our continent. I am very skeptical about the merits of this strategy. It will be some time before Europe is sufficiently integrated and the many barriers – regulatory, fiscal and cultural – that impede the functioning of the single market are overcome. "[10] A related view is expressed by the European Financial Services Round Table (EFR, 2003, p.1*):* "The European Financial Services Round Table believes that the lack of harmonization of supervision and regulation is an important obstacle to the development of cross-border financial services."

3. Supervision

The current system of harmonized supervision reflects the gradualist approach pursued since the 1970s. The underlying philosophy aims to combine harmonization (in terms of minimum standards) with flexibility for national authorities to complement minimum measures by steps reflecting national idiosyncrasies in institutional and market structures. National measures are subject to mutual recognition.

Major advances along this route include the first Banking Co-ordination Directive of 1977 specifying the definition of a credit institution and the criteria for granting a banking license; the 1983 directive on carrying out consolidated supervision; the 1986 rules on account harmonization, the 1989/1993 2nd Banking Co-Ordination Directive establishing home control; the 2000 EU directive relating to the taking-up and pursuit of the business of credit institutions introduced a single EU bank license as well as a number of other measures on issues ranging from deposit insurance to the own funds, solvency ratio and large exposures directives.[11] Further progress to integration is expected from the implementation of the *Financial Services Action Plan* (FSAP) agreed at the Lisbon Summit. The FSAP sets out reforms in the areas of financial law, regulation and taxation. The forty-two individual measures are scheduled for implementation by 2005.

---

[9] Schoenmaker (2003) reaches a similar conclusion: "Summing up, the process of integration of 15 national financial systems is not yet completed. While wholesale markets are generally largely integrated …. Retail markets are still largely fragmented within the EU."

[10] Botin (2004).

[11] See Hadjiemmanuil (1996) for a detailed discussion.

Implementation of supervision remains at the national level. Foreign subsidiaries are supervised under the principle of consolidated solvency supervision by the home country authority, but are also subject to individual (non-consolidated) supervision by the host country. Branches are solely supervised by the home authority for solvency purposes, with the host authority having a supervisory function in liquidity matters.

National control is augmented by extensive co-operation and co-ordination. The Eurosystem is charged (Art. 105(5)) with contributing "to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" and enjoys a consultative and advisory role in the rule making process (Padoa-Schioppa, 1999).

3.1 Domestic Supervisory Arrangements

The traditional arrangement in which banking supervision (and banking supervision only) was undertaken by the central bank has been re-examined from two angles over the last two decades. A first line of inquiry focuses on whether continued cross-sector integration renders the traditional sectoral focus of supervision obsolete, an issue taken up in the 1999 guidelines of the Basel Committee on the Supervision of Financial Conglomerates. A second line of inquiry examines the desirability of the monetary authority also having supervisory responsibilities.

3.2 Sectoral Versus Integrated Systems

While arrangements remain diverse, the last decade has witnessed a shift from de jure separate supervisors in the banking, insurance and securities sectors to de jure integrated supervisors, following the proposal of the Lamfalussy group. Twelve Member States, including Germany and the United Kingdom, have chosen to unify financial supervision in a single agency; while eleven Member States, including France and Italy, retain a specialized banking supervisor. Two states, Finland and Luxembourg, combine banking with one other sector for supervisory purposes.

These de jure institutional differences are likely to overstate the practical divergence as de facto integration has proven difficult; reflecting differences in the underlying motivation for regulation (systemic risk versus consumer protection), in the types and extent of regulations, and not least the typical specialization and separation of the supervisors themselves present obstacles to operational integration.

Table 1: Institutional Arrangements for Financial Market Supervision in EU Countries

Unified supervisory agency	**Banking supervision integrated with one other supervisory area**	**Specialized banking supervisor**	**Specialized insurance supervisor**	**Specialized securities supervisor**
Austria	Finland (I)	Cyprus (CB)	Cyprus (G)	Cyprus (SA)
Belgium	Luxembourg (S)	Czech Republic (CB)	Czech Republic (SA)	Czech Republic (SA)
Denmark		France (CB,AS)	Finland (SA)	France (SA)
Estonia		Greece (CB)	France (SA)	Italy (SA)
Germany		Italy (CB)	Greece (G)	Lithuania (SA)
Hungary		Lithuania (CB)	Italy (SA)	Poland (SA)
Ireland (CB)		Poland (CB)	Lithuania (SA)	Portugal (SA)
Latvia		Portugal (CB)	Luxembourg (SA)	Slovakia (SA)
Malta		Slovakia	Poland (SA)	Slovenia (SA)
Netherlands(CB)		Slovenia (CB)	Portugal (SA)	Spain (SA)
Sweden		Spain (CB)	Slovakia (G)	
U.K.			Slovenia (G)	
			Spain (SA)	

Note: B,I,S — Banking, Insurance, Securities supervision. Italics identify countries in which the national central bank remains fully or partially responsible for banking supervision. CB: supervision by central bank. G: supervision by government department, SA: supervision by supervisory agency. Source: Grünbichler and Darlap (2003 and web pages of national central banks and supervisory agencies).

3.3 Central Bank Involvement

> *“The Eurosystem strongly supports a continued involvement of national central banks in prudential supervision, although the institutional set-up of financial supervision needs to be tailored to the structure of the respective national financial system.” (Duisenberg, 2002).*[12]

The supervisory role of the (national) central bank presents a second area of institutional differences. An evolving debate explores the desirability of allocating

[12] Duisenberg (2002).

supervisory authority to central banks.[13] Arguments for a separate agency include the potential for conflicts between monetary policy objectives and financial stability objectives; arguments in favor of retaining a formal role for the central bank focus on synergies and information sharing, notably with respect to maintaining a smoothly functioning payment system.

In EU members retaining a separate banking supervisor, the central bank is the overwhelming candidate to fulfill this role, though the potential conflict between monetary policy and financial stability objectives does not arise in the case of the EMU members France, Greece, Italy, Portugal and Spain. On an operational level, close cooperation between the central bank and the supervisory agency – including cross representation at the respective boards – remains the rule even in countries with unified supervision in a separate institution outside the central bank.

The ECB does not have formal responsibility for prudential supervision. However, under Art (105 (6)) it can be given such tasks without a treaty amendment, leaving open a relatively straightforward avenue towards a merger of the monetary policy and the supervisory function on the ECB level should such an expansion of responsibility be desired at a future time (Hadjiemmanuil, 1996).

3.4 Supervisory Co-ordination

Table 2: Fora for Formalized European Co-operation in Banking and Insurance Supervision

	Banking	**Insurance**	**Securities**	**Conglomerates**
Level 2 Regulatory Committees	**EBC** European Banking Committee	**EIC** European Insurance Committee (includes Pension Funds)	**ESC** European Securities Committee	**FCC** Financial Conglomerates Committee (FCC)
Level 3 Supervisory Committees	**CEBS** Committee of European Banking Supervisors	**CEIOPS** Committee of European Insurance and Occupational Pensions Supervisors	**CESR** Committee of European Securities Regulators	

Source: Grünbichler and Darlap (2003).

While the primary supervisory authority resides at the member state level, in practice supervision incorporates an extensive multi-lateral component operating

[13] See Hadjiemmanuil (1996), Eijffinger and de Haan (1996), Eijffinger (2001), Duisenberg (2002), García Herrero and del Río (2003) and Grünbichler and Darlap (2004) inter alia. Di Giorgio and Di Noia (2002) discuss a more disaggregated structure distinguishing between microeconomic stability; investor protection and proper behavior; and efficiency and competition.

through a network of coordinating bodies.[14] The three-level structure comprises on the first level the Ecofin Council and the Parliament setting the broad framework. On the second regulatory committees vote on proposals of the European Commission for technical implementation measures; while level 3 committees advise the European Commission on “level 2 measures” and promote the consistent implementation of EU directives as well as the consistent implementation and convergence of supervisory practices. While the institutional structure includes a level 2 (and an optional level 3) committee on financial conglomeration, the current setting is primarily focused on sector-specific supervision.

Operating within this framework, as well as in broader multilateral groups, consistency of supervisory practice across Member States has markedly improved in recent years. Yet more work remains to be done. In a recent analysis focusing on the EMU area, Padoa-Schioppa (2003) concludes that “The EU and the Euro area are now very far from this (unified) standard. Supervisory reporting requirements and rulebooks still differ markedly between countries” (p. 298). Speaking from the banker’s perspective, Anton van Rossum, CEO of the Dutch/Belgian Fortis Group, takes a similar view: “Integration of the European financial markets makes the economy grow. […] European cross border banks and insurers are helping this integration by offering their customers a more pan-European product range, promoting pan-European best practices and having by definition a less protectionist attitude. But our cross-border activities are hampered by different sets of rules and supervising mechanisms. These hurdles block potential benefits.”[15] Recent reviews of banking supervision in individual EU countries in the context of the International Monetary Fund’s Financial Sector Assessment Program (FSAP) reach similar conclusions.[16]

3.5 Looking Forward

> *“International competition among bank regulators will not, in general, be efficient when regulators maximize national welfare, lenders are unable to monitor bank behavior, and there are foreigners among the lenders and/or bank owners whose preferences are not taken into account by the regulators.”* (Sinn, 2003, p. 173).

[14] The structure of these groupings has itself responded to ongoing developments. It was substantially modified in 2004, roughly along the lines of the Lamfalussy framework covering European Securities Supervision.
[15] Cited in release by the Insurance Journal, Europe’s Banks and Insurers Appeal for Regulatory Harmonization”, October 29, 2003: www.insurancejournal.com/news/newswire/international/2003/10/29/33618.htm
[16] For examples of assessments see http://www.imf.org/external/np/rosc.

If initiatives aimed at reducing border effects in financial markets succeed in creating a true European financial market, will the current arrangement of harmonized national supervision augmented by cross-border co-ordination remain best suited to address future challenges? Should it be replaced by a *European System of Financial Supervisors* structured along the lines of the ESCB? If so, should it cover all sectors or be sector-specific? If sector-specific, should the central agency be the ECB itself or a separate body? Should it cover all banks, or only banks exceeding a specified threshold in terms of cross-border activity?

These questions have been explored since the early 1990s, as yet with no clear consensus. An active literature explores the more general issue of whether national supervision remains efficient in an integrated financial market, as well as the more specific EU concerns.[17] The tenor of the literature is skeptical on the longer-term merits of combining national supervision with the objective of an integrated EU financial market, pointing out a number of potential problem areas:

3.6 Inference Problems:

Even with information sharing arrangements, is the national supervisor likely in practice to have access to all relevant information, specifically, will a national supervisor be able to identify problems arising from the interaction of smaller problems in different foreign locations, each of which by itself may not be viewed as problematic?

3.7 Supervisory Competition Problems:[18]

Are there incentives that will lead to competition between supervisors to produce less costly (but socially sub-optimal) de facto supervision, in particular in light of the new flexibility introduced with Basle II?

---

[17] Recent contributions include Prati and Schinasi (1999), EFC (2000), Lannoo (2000), Belaish, Kodres, Levy and Ubide (2001), Vives (2001), Acharya (2003), Dalen and Olsen (2003), Dell’Ariccia and Marquez (2003), Schoenmaker (2003), Holthausen and Rønde (2004).

[18] See Sinn (2003).

3.8 Incentive Problems:[19]

Will cross-country differences in the incidence of the costs and benefits of a supervisory action (for example, the allocation of the cost of deposit insurance, bailouts or indeed bank failures) lead to decisions that are optimal from a national but not the aggregate perspective for banks that have important foreign operations?

The first problem area is least intractable, and is addressed through the system of information sharing reviewed above. The second and third areas are more fundamental. To the extent that such problems do arise, the case for a multi-lateral supervisory agency for multi-national banks that internalizes the externalities is strengthened; though the traditional approach of harmonization may also go a long way in addressing specific issues.

While an EU level supervisory agency eliminates some of the externalities that will potentially plague the current system as cross-border activity grows in importance; moving to a multi-lateral agency also carries significant disadvantages and may encounter obstacles. First, practicing supervisors emphasize the benefits of proximity between the supervisor and the supervised; a proximity that would be negatively impacted by a move to an EU level supervisory agency. The argument of course loses strength to the extent that the very process of enhanced cross-border activity erodes the role of the headquarter as an information hub. Second, some decisions by an EU-level supervisor, in particular a bank closure, carries potentially sizable fiscal implications for the Member States.

These difficulties notwithstanding, the longer-term evolution of supervisory arrangements points in one direction. If supervisory arrangements in the EU were newly created today, it is very unlikely that the current system would be chosen: efficiency considerations suggest matching the spatial purview of the supervisory agency with the spatial business purview of the supervised banks to reduce externalities.

The optimal transition arrangement from the current system to a multilateral supervisor is far less evident. Should it be revolutionary, transferring supervisory authority proactively from national to a new EU supervisory agency? Or should it be evolutionary – retaining the current system with a continued emphasis on the harmonization of practices with a gradual evolution of the current coordinating bodies into the nucleus of a future EU supervisory agency; with a full functional

[19] Along these lines, Holthausen and Rønde (2004) show that in the case of banks with foreign branches, adherence to the guidelines of the Basel Committee would not necessarily lead to full sharing of *soft* (non balance sheet) information for a closure decision if the home and host country supervisor have different interests, reflecting, for example, a different systemic importance of the bank in the two countries. Sinn (2003) explores the consequences of foreign depositors and foreign bank equity holders on the decision making process of a national regulator in the context of international competition.

transfer and the creation of an institutionalized EU supervisory agency coming at the end of a potentially quite extensive transition phase?[20] Should it cover all banks, or be initially limited to banks exceeding set thresholds in terms of size and international orientation; with national supervisors retaining authority for the remaining banks?

In our view, a number of factors argue for a gradualist approach initially focusing only on the small subset of banks that can be truly described as multinational:

- The case for a multi-lateral supervisor rests on the importance of cross-border activity, spillovers and externalities. As reviewed above, the fully integrated European (retail) banking system however remains a distant goal.
- The potential problems identified in the theoretical literature notwithstanding, the current system of national supervision determined by the headquarter location augmented by extensive coordination and information sharing has a strong track record.
- In the near future European banking and insurance concerns will experience substantial change in the wake of Basle II, Solvency II, ongoing and planned revisions to International Accounting Standards (IAS) and other changes. Prudence argues against undertaking large changes in supervisory arrangements with their unavoidable initial hiccups in a period already presenting supervisors with substantial challenges.

Conversely, however, the ability of the current system to cope with these changes provides a test case for their quality. The Basel II agreement enhances the discretion of national banking supervisors to assess relative risk while the *Solvency II* framework currently worked out for the European Insurance industry proposes a capital framework based more directly on individual companies' risk profile.[21] Given the differences in national practices rooted in the historical idiosyncrasies, enhanced discretion carries the possibility that standards will be differently applied across EU Member States. Whether the proposed measures to

---

[20] While no such transfer is currently envisaged, the political tussle regarding the location for meetings of the Level II and Level III committees suggests expectations of greater future importance.

[21] Solvency II is a two-phased project aimed at reviewing the European framework for the prudential supervision of insurance companies and establishing a solvency system that better matches the true risk profile of insurance undertaking than that of the present system. The full implementation of Solvency II will need to await the implementation of International Accounting Standards Board (IASB) new guidelines. The timeline for the full implementation of Solvency II remains open.

ensure consistent implementation[22] will prove sufficient to cope with these challenges will influence the debate on the need and timing for institutional reform.

An evolutionary approach also appears appropriate regarding the sectoral unification of supervision. Experience over the last years suggests that the de facto integration of sectoral supervision is a difficult and long-term task proceeding far beyond their de jure placement under a single task.[23] Given these practical difficulties, undertaking both sectoral and cross-border integration at the same time appears over-ambitious relative to an approach emphasizing increased information sharing between sectoral supervisors while reserving decisions about institutional formats for a later point. For the same reason, it appears prudent to delay any decision on the formal role of the ECB in an eventual multilateral supervisory arrangement and instead to focus on improved co-ordination within the level 2/3 framework.

4. Crisis Management

Beyond the challenges of day-to-day supervision, financial integration raises important issues for the prevention of financial crises and the structure of the crisis management framework. Crisis prevention is based on effective supervision, effective early warning systems, and an appropriate “prompt corrective actions” framework. In the emerging European context, crisis prevention will depend critically both on the effectiveness of the supervisory coordination outlined above, and on a speedy agreement on the measures to be taken to isolate the institution and avoid a further spillover of the problem. The informational and incentive problems reviewed above thus arise in this context as well.

If a crisis cannot be prevented, crisis management assumes center stage. In the EU context, crisis management, depending on the nature of the troubled institution may have to involve (i) differently structured national supervisory agencies, (ii) national central banks with sharply differing scopes for LOLR actions, (iii) national treasuries (some restrained by the stability and growth pact) and (iv) the ECB. As integration proceeds, this complex system is likely to encounter operational difficulties.

Compared to the gradual but steady progress made in adjusting supervisory arrangements to the process of European financial integration, crisis response arrangements have undergone less formal institutional adjustment; and remain the subject of spirited debate. Two recent reports on financial security commissioned

[22] For details see press release of the 2471st ECOFIN Council meeting of December 2, 2002.

[23] A recent reorganization of the Financial Services Authority (FSA) enhancing the focus on systemically important institution bears witness to an evolution of supervision even in a technically unified setting.

by the Ecofin Council ("Brouwer I", 2000 and "Brouwer II", 2001) examine the crisis management capabilities of the current system. The reports take an overall optimistic tone, but emphasize the need for further improvements, notably in information sharing arrangements. This has been taken up in the March 2003 multilateral Memorandum of Understanding (MOU) between the ECB, the EU and national central banks and financial regulators.[24] The MOU, which complements and partially replaces the existing web of bilateral MOUs, sets out principles for the scope and mechanisms of cross border cooperation and the distribution of responsibilities in crisis management situations as well as information sharing arrangements and logistical arrangements. In other areas, such as the identification of a lead institution, it is less specific. As the financial system evolves, these arrangements must be revisited and reassessed. The following paragraphs take up some of the pertinent issues.

4.1 Deposit Insurance and Guarantee Schemes

The objectives of EC Directive 94/19/EC of May 1994 regarding the harmonization of deposit insurance schemes have been substantially achieved.[25] The insurance schemes are generally seen as adequate; consequently there has not been a strong push for the establishment of a multi-lateral system (Schüler, 2003). That said, some potential problem areas exist, in particular regarding the responsibility of the home country deposit scheme for liabilities arising in foreign branches.

In contrast to the banking (and the securities) sector only a few EU Member States have explicit insurance guarantee schemes in place. While the absence of such schemes creates additional challenges if an insurance company has to be wound down, systemic effects of insurance company failures are less likely given the different nature of insurance sector liabilities.

4.2 Lender of Last Resort Function I: Actors

The arrangements for lender of last resort functions (and more generally the issue of a lead institution) have been the subject of spirited debate. The split of the 25 EU Member States into twelve countries sharing a common central bank, two countries with permanent opt-out rights and eleven countries headed for eventual adoption of the Euro raises a number of tricky issues. Under current arrangements, supervision and LOLR functions remain on the same level: national central banks

[24] See ECB (2003).

[25] See Garcia (2000) and, for the case of the accession economies, Nenovsky and Dimitrova (2003).

will provide LOLR assistance to systemically important institutions within their jurisdiction.

For the EMU members, the capacity for monetary LOLR actions is however limited, turning attention to the role of the ECB. While the Maastricht Treaty does not grant the ECB a formal LOLR function, it opens the door to support actions through the responsibility for the payment system. Market expectations seem to view such actions as likely in case of systemic problems: the "absence of a euro area wide institution that would be able to put together a rescue package at a moment's notice implies that the ECB might have to keep the Euroland financial system afloat in the event of a major financial accident." (Morgan Stanley, 2002). The likely de facto emergence of the ECB as a LOLR in cases of systemic crisis raises the question whether such a role should not be pre-specified in order to reduce uncertainty (Goodhart, 2000, Vives, 2001). Importantly, this debate is not so much about the principal capacity or even willingness of the Eurosystem to respond to a crisis, but rather about the desirability of specifying arrangements ex ante. In the longer term, an evolving debate concerns the desirability of shifting the responsibility for bailouts to a separate, fiscal agency.

4.3 Lender of Last Resort II: Burden Sharing

Two issues arise in the allocation of costs of LOLR actions. First, the traditional allocation of costs to the country in which the institution is headquartered becomes problematic as EU-wide operating banks headquartered in smaller economies become more prevalent. Second, the treatment of the often-sizable fiscal costs of such operations under the SGP requires clarification.

4.4 Lender of Last Resort III: Coverage

Under current arrangements, the immediate response to a possible crisis situation differs depending on the type of institution (initially) affected. While troubled banks would be considered for a monetary LOLR operation by the national central banks, other financial institutions, or financial conglomerates not led by banks, would have to look towards an industry organized life-boat operation or to a direct budgetary bailout. As the trend towards closer cross-sectoral integration of financial institutions continues, and as, in consequence, the possibility of cross-sectoral financial crisis transmission rises, this traditional allocation of potential access to LOLR operations requires reconsideration.

5. Conclusion

The process of financial integration is fluid, as must in consequence be the supervisory and crisis management responses. In many areas, the most pertinent question is not so much *what*? but rather *when* and *how*?

On supervision, the final destination is clear. As the long held objective of a true European financial marketplace is realized, the supervisory arrangements must likewise adapt from the national to the European level (at least for the top tier of multi-national banks) to reduce negative externalities. The optimal timing of the transition is less clear. Moving immediately to integrated multi-lateral supervision has distinct advantages in terms of consistent information gathering and the reduction of potential problems from competing standards and different incentives. Yet such a revolutionary move also has significant drawbacks. Our assessment favors a continuation of the current cautious *evolutionary* approach, with a gradual transfer of supervisory authority to the EU level, plausibly taking place within the current set of co-ordinating bodies.

On crisis management, the challenges are different. One can reasonably envisage scenarios in which problems of a large bank headquartered in a smaller member over-stretch the capacity of the national central bank. One can equally imagine circumstances in which taxpayers in a particular Member States are unwilling to bear the entire burden of supporting a bank active in multiple Member States. While such problems would likely be addressed in an ad hoc and case specific manner, the absence of a well-defined structure creates potentially detrimental and counter-productive uncertainty. In our view the case for further clarification of crisis management policies and burden sharing is strong.

References

Acharya, V. (2003) Is the International Convergence of Capital Adequacy Regulation Desirable?, Journal of Finance 58, 2745–2782.

Lieven B., A. Ferrando, P. Hördahl, E. Krylova and C. Monnet (2004) Measuring Financial Integration in the Euro Area, European Central Bank Occasional Paper Series No. 14, April.

Belaish, A., L. Kodres, J. Levy and A. Ubide (2001) Euro-Area Banking at the Crossroads, IMF Working Paper No. 01/28.

Berger, A., R. Demsetz and P. Strahan (1999) The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future, Journal of Banking and Finance 23. 135–194.

Berger, A. R. DeYoung and G. Udell (2000) Efficiency Barriers to the Consolidation of the European Financial Services Industry, European Financial Management 7, 117–130.

Berger, A. Q. Dai, S. Ongena and D. Smith (2003) To What Extent Will the Banking Industry Be Globalized?, Journal of Banking and Finance 27, 383–415.

Botin E. (2004) The Most Profitable Course for Europe's Banks, Financial Times, Thursday, January 22, p. 13.

Brousseau, V. and C. Detken (2001) Monetary Policy and Fears of Financial Instability, ECB Working Paper No. 89, 44 pages.

Buch, C. (2001) Cross-Border Banking and Transmission Mechanisms: The Case of Europe; Kiel Working Paper No. 1063.

Buch, C. and G. DeLong (2002) Cross-Border Bank Mergers, mimeo.

Cabral, I., F. Dierick and J. Vesala (2002) Banking Integration in the Euro Area, ECB Occasional Paper No. 6, 52 pages.

Conference of Insurance Supervisors of the Member States of the European Union (1997) Solvency of Insurance Undertakings.

Crockett, A. (2004) Banking Needs a New Basel Accord, Financial Times, Tuesday, January 27, p. 15.

Dag Morten, D. and T. E. Olsen (2003) Regulatory Competition and Multinational Banking, CESIFO Working Paper No. 971.

Danthine, J., F. Giavazzi, and E.L. von Thadden (2000) "European Financial Markets after EMU: A First Assessment", NBER Working Paper No. W8044.

Danthine, J., F. Giavazzi, X. Vives and E.-L. von Thadden (1999) The Future of European Banking, CEPR 9, Monitoring European Integration Series.

De Bandt, O. and P. Hartmann (2000) Systemic Risk: A Survey, ECB Working Paper No. 35, 77 pages.

Dell'Ariccia, G. and R. Marquez (2003) Competition among Regulators and Credit Market Integration; mimeo, University of Maryland.

Dermine, J. (2003) European Banking: Past, Present and Future, in: Gaspar V., P. Hartmann and O. Sleijpen (eds.), The Transformation of the European Financial System, ECB, Frankfurt.

Di Giorgio, G. and C. Di Noia (2001) Financial Regulation and Supervision in the Euro Area; Discussion Paper 01–02, Financial Institutions Center, Wharton, University of Pennsylvania.

Duisenberg, W. (2002) The Role of the Eurosystem in Prudential Supervision, Speech, Amsterdam, April 24, BIS Review 27.

ECB (2003) Memorandum of Understanding of High-Level Principles of Cooperation between Banking Supervisors and Central Banks of the European Union in Crisis Management Situations.

Economic and Financial Committee (2000) Report on Financial Stability, ("Brouwer I"), Economic Papers No. 143.

Economic and Financial Committee (2001) Report on Financial Crisis Management, ("Brouwer II"), EFC/ECFIN/251/01: http://ue.eu.int/uedocs/cmsUpload/Brouwer%20Report%20on%20Financial%20Crisis%20Management.pdf

Eijffinger, S. 2001, Briefing paper on The Conduct of Monetary Policy for the European Parliament, mimeo.

Eijffinger, S. and J. DeHaan (1996) The Political Economy of Central Bank Independence, Princeton Special Papers in International Economics No. 19.

Elsinger, H., A. Lehar and M. Summer (2002) Risk Assessment for Banking Systems, Oesterreichische Nationalbank, Working Paper No. 79, 49 pages.

Eschenbach, F. and L. Schuknecht (2002) The Fiscal Cost of Financial Instability Revisited, ECB Working Paper No. 191, 44 pages.

European Commission, Economic and Financial Committee (2001) Report on Financial Crisis Management, Economic Paper No. 156: http://europa.eu.int/economy_finance

European Commission (2002) Study into the Methodologies to Assess the Overall Financial Position of an Insurance Undertaking from the Perspective of Prudential Supervision (KPMG report).

European Financial Services Roundtable (2003) Harmonization of Regulation and Supervision of the European Financial Sector, mimeo.

Gillian, G. (2000) Deposit Insurance: Actual and Good Practice, International Monetary Fund, Occasional Paper No. 197, 93 pages.

Goodhart, C. (ed.) (2000) Which Lender of Last Resort for Europe, Central Banking Publications, London.

Grünbichler, A. and P. Darlap (2003) Regulation and Supervision of Financial Markets and Institutions, Austrian Financial Markets Authority,

Hadjiemmanuil, C. (1996) The European Central Bank and Banking Supervision, Essays in International Financial and Economic Law No. 3, September, London.

Hartmann, P., A. Maddaloni and S. Manganelli (2003) The Euro Area Financial System: Structure, Integration and Policy Initiatives, Oxford Review of Economic Policy 19:1, 180–213.

Hartmann, P., M. Manna and A. Manzanares (2001) The Microstructure of the Euro Money Market, Journal of International Money and Finance 20:6, 895–948.

Herrero G., A. and P. del Río (2003) Financial Stability and the Design of Monetary Policy; mimeo.

Hoelscher, D. S. and M. Quintyn (2003) Managing Systemic Banking Crises, International Monetary Fund, Occasional Paper No. 224.

Holthausen, C. and T. Rønde (2004) Cooperation in International Banking Supervision, European Central Bank, Working Paper No. 316, March.

Kaufman, G.G. and K. E. Scott (2000) Does Bank Regulation Retard or Contribute to Systemic Risk, Stanford Law School Working Paper No. 211, Stanford.

Lannoo, K. (2000) Challenges to the Structure of Financial Supervision in the EU, mimeo, Brussels, CEPS.

Manna, M. (2004) Developing Statistical Indicators of the Integration of the Euro Area Banking System, European Central Bank Working Paper No. 300, January.

Meister, E. (2000) Challenges for Regulators in Europe; Speech, BIS Review 81.

Morgan, S. (2002) Euro Tower Insights, Equity Research Europe, October 28.

Nenosky, N. and K. Dimitrova, Deposit Insurance During EU Accession, Working Paper No. 617, The William Davidson Institute.

OECD (2002) Insurance Solvency Supervision: OECD Country Profiles, Paris.

Padoa-Schioppa, T. (1999) EMU and Banking Supervision, Lecture given at the LSE, , February 24, mimeo.

Padoa-Schioppa, T. (2003) Central Banks and Financial Stability, Exploring the Land in Between, chapter 7, in: Gaspar V., P. Hartman and O. Slejpen (eds.), The Transformation of the European Financial System, 270–310, Second ECB Conference, Frankfurt, 2003.

Prati, A. and G. J. Schinasi (1998) Ensuring Financial Stability in the Euro Area, Finance and Development 36:4.
Prati, A. and G. J. Schinasi (1999) Financial Stability in European Economic and Monetary Union, Princeton Studies in International Finance No. 86.
Reszat, B. (2004) How Has the European Monetary Integration Process Contributed to Regional Financial Integration? HWWA 2004, mimeo.
Repullo, R. (2001) A Model of Takeovers of Foreign Banks, Spanish Economic Review 3, 1–21.
Schoenmaker, D. (2003) Financial Supervision: from National to European?; Financial and Monetary Studies.
Schüler, M. (2001) The Threat of System Risk in Banking: Evidence for Europe, Zentrum für Europäische Wirtschaftsforschung, Discussion Paper No. 02–21.
Schüler, M. (2003) How do Banking Supervisors Deal with Europe Wide Systemic Risk, Zentrum für Europäische Wirtschaftsforschung, Discussion Paper No. 03–03.
Sharma, P. (2002) Prudential Supervision of Insurance Undertakings, December.
Sinn, H. W. (2003) The New Systems Competition, chapter 7, Blackwell Publishing, Malden.
Stolz, S. (2002) Banking Supervision in Integrated Financial Markets: Implications for the EU, CESIFO Working Paper 812, 19 pages.
Summer, M. (2002) Banking Regulation and Systemic Risk, Oesterreichische Nationalbank, Working Paper No. 57, 41 pages.
Vives, X. (2001) Restructuring Financial Regulation in the European Monetary Union, Journal of Financial Services Research 19, 57–82.