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Comment on Anne-Marie Gulde and Holger Wolf: "Financial Stability Arrangements in Europe: a Review"

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1. Introduction

In discussing Anne-Marie Gulde's and Holger C. Wolf's paper regarding *The Institutional Setting for Financial Stability in Europe*, I would like to start with recalling the first headline of the presentation: "May you live in interesting times". On my opinion, this sentence fully characterises the current discussion about the future institutional setting for financial stability in the European Union.

Even though this discussion is not new and has only recently led to the introduction of the so-called Lamfalussy-approach in the securities field (2001) and then in all financial services sectors, over the recent months the discussion process has again gained momentum. The main reasons have been highlighted in the paper: the EU enlargement and the introduction of the euro, the financial integration process, Basel II with its more qualitative and process-based approach and the International Accounting Standards (IAS). In addition, the issue of efficiency and effectiveness of supervision became increasingly important.

The paper provides a very good analysis of some of the challenges emerging from these structural and regulatory developments, and a number of interesting suggestions are put forward in this respect. In providing comments, I focus at first on the analysis of current trends in the banking sector and then on supervisory issues; last but not least, I have a few comments on the issue of crisis management.

2. Structural Trends

In the paper, a number of trends in the banking sector have been highlighted, which indicate that European Financial Markets are not yet fully integrated. This is clearly an important fact, given that it implies that national specificities are still of importance and need to be appropriately addressed.

In addition, I would like to mention some further observations which might be relevant in this context:

Firstly, cross-border activities of banks have become increasingly important, which is particularly true for the new EU Member States, where on average nearly 70% of banking assets are controlled by foreign banks, mostly from other EU countries.

Secondly, major banking groups have continued to reorganise their activities, driven by search for increased efficiency. This has on one hand led to the centralisation of certain functions on banking group level, for example risk management and liquidity management; on the other hand, other lines of business, in particular support activities, have been outsourced outside the group.

Thirdly, some banking groups could consider adopting the new European Company (SE-) Statute and transforming their subsidiaries into branches. So far, there are no indications that the SE-Statute would be widely adopted, but it is clear, that this would have major impact from a supervisory perspective, in particular in case of systemic relevant branches, and lead to a shift in supervisory responsibilities from the host country to the home country.

Whatever the institutional supervisory setting looks like, it seems clear that these three issues require a close monitoring, some sort of common approach and supervisory co-operation.

3. Supervision and Regulation

3.1. Current Institutional Setting

Before analysing the proposals for the future institutional supervisory setting, it might be useful to briefly summarise the main elements of the current supervisory arrangements. Most of them have also been mentioned in the paper:

3.1.1 National Responsibility for Banking Supervision

In principle, banking supervision is a national responsibility and conducted by national supervisors. In the paper, the differences in the national supervisory arrangements have been pointed out, which relate mainly to sectoral versus integrated supervision and whether the central bank is involved or not. As regards the latter, several types of involvement are possible, and in fact, in the EU-25 there are only three cases where there is no central bank involvement in banking supervision at all.

Moreover, in the Netherlands another concept has recently been added to this variety of arrangements, based on a *functional* or *horizontal* distinction between prudential supervision on one hand and conduct-of-business supervision on the other hand. Prudential supervision is the task of the central bank.

These differences indicate that there is no *best supervisory system*, but that besides historical reasons for different solutions, each country has to find a system which optimally fits into its general framework in terms of acceptance, effectiveness and economic benefit. This has to be kept in mind when any suggestions for a single supervisory system on EU level are considered.

3.1.2 Harmonisation of Certain Minimum Standards and Mutual Recognition

As regards the second principle, a number of EU-directives have created a common regulatory framework based on the principle of minimum harmonisation. In the paper, the EU passport was mentioned in this context. This passport, which has already been introduced in 1989, allows each bank licensed in and supervised by a Member State to conduct its business in all other Member States, either through a branch or through providing cross-border services. In addition, with a view to subsidiaries, the concept of consolidated supervision is a key element, since it ensures an overall perspective over the banking group.

3.1.3 EU/EEA Co-ordination and Co-operation

Finally, as regards the third principle, co-operation and co-ordination arrangements have been established on bilateral and multilateral basis. In this respect, the level 2 and level 3 committees under the so-called Lamfalussy-approach are of particular importance. Further, with a more macro-prudential focus, co-operation between central banks and banking supervisors also takes place in the Banking Supervision Committee of the European System of Central Banks (ESCB). These committees are embedded in a complex supervisory and regulatory framework.

3.2. Challenges for Supervision

3.2.1 Future Supervisory Arrangements

So far as with regard to the current supervisory arrangements. In the paper it is argued that “if supervisory arrangements in the EU were newly created today, it is very unlikely that the current system of *national supervision plus* for all banks would be chosen over alternative two-tier arrangements with a multi-lateral agency supervising banks above some size and internalization threshold, and national supervisory agencies retaining responsibility for smaller banks operating primarily in their domestic market."

In this respect, I have a number of comments and questions:

First, and most importantly, I think that the suggested approach bears a high risk of divergent developments of supervisory rules and practices. This could further lead to a potential distortion of local market level-playing fields, given that large and small banks would be subject to different supervisory regimes. However, they would continue to carry out their activities in the same local markets. Different rules and reporting schemes would also make it difficult to ensure an overall assessment of the development of the respective national financial market. Therefore, my question is how a consistency of rules and practices could be ensured?

Second question: How and at which level should the decisive threshold be defined? If it is low, there could be a risk that the central supervisor will soon be overburdened, which might have negative effects on the quality of supervision and finally, on financial stability. Further, if a bank extends its cross-border activities, from my understanding it could suddenly happen that it would be subject to a different supervisory regime, which would not only imply new rules for the respective bank, but also that new supervisors would more or less have to start from the scratch to get a picture of it.

In addition, a two-tier structure would probably require a dual regime as regards crisis management, deposit insurance, etc. Would this not significantly complicate the supervisory framework?

Finally, as also mentioned in the paper, it is likely that the information advantages based on the current proximity of supervisors and supervised institutions would be lost, again with potential implications for financial stability.

I think that it could be very interesting to further deepen the discussion on these issues. It might also be worth noting that the German government recently issued a paper[1], in which a similar approach has been suggested: A European system of financial supervision should be created, with supervision of providers of financial services who operate solely at national level remaining with the national authorities.

3.2.2 Transitional Arrangements

Concerning the suggested transition arrangements in the paper, a preference is expressed for an evolutionary or gradualist approach: The current coordinating bodies, I suppose reference is made here to the level 3 committees, should be the nucleus of a future supervisory agency, gradually assuming more responsibilities,

[1] Growth and Employment for the Years through 2010. Position of the German Government on the Mid-term Review of the Lisbon Strategy (October 2004).

with a full functional transfer and the creation of an institutionalised EU supervisory agency coming at the end of a potentially quite extensive transition phase. Further, it is proposed that an evolutionary approach would also be appropriate regarding the sectoral unification of supervision.

In a consultation paper[2] issued at the end of October 2004, CESR – the Committee of European Securities Regulators – similarly considered that the legal profile of CESR could be upgraded in order to allow single EU decisions. However, it was noted that all available tools under the current framework should be explored before envisaging more far reaching approaches and that so far there is no need for such an upgrading. Moreover, in the CESR paper it was also explained that issues related to the prudential supervision of banks or insurance companies are not covered, given that they are of fundamental different nature and focus.

Personally, I think, and now I refer again to the banking sector, that some kind of mixed responsibilities, which are inherent to the described evolutionary approach, bear the potential of substantial problems: How can the respective competences and responsibilities be clearly assigned to one authority or the other? What about liability? What about crisis management? etc.

These problems become even more obvious in the context of the so-called lead supervisor approach, which is favoured by some large European banking groups and which is also often seen as interim solution on the way to the final objective of a European Supervisory Authority. According to this approach, the supervisor of the parent institution should be assigned substantial – if not all – supervisory competences in relation to the subsidiaries. However, this would also imply the described legal problems, could distort the level playing field and would in several cases lead to the result that one jurisdiction is responsible for supervision while another one would have to pay in case of a crisis.

Against this background, and in order to avoid these problems, I am more of the opinion that a clear move to a new system would be preferable, provided that the essential preconditions are fulfilled. However, I fully agree that for the time being, any quick move to a new system would be clearly premature and at this stage not appropriate: the single market is not yet sufficiently integrated, the current co-operation system has a strong track record and has only recently been reformed and, finally, the regulatory framework is currently subject to substantial changes due to Basel II, Solvency II, etc.

3.2.3 Alternative Approach

From my personal opinion, any shift to a more centralised supervisory approach would have to comply with the following criteria:

[2] Preliminary Progress Report: Which Supervisory Tools for the EU Securities Markets? An analytical paper by CESR (Ref: 04-333f/October 2004).

Firstly, I consider it as important that any concepts provide for clear structures and responsibilities, in the transitional period as well as in the final stage.

Secondly, as I have just mentioned, I do not think that the current supervisory system should be changed for the time being: In particular, since the financial market is not yet fully integrated and national specificities have to be taken into account, not least from a financial stability point of view. It should be considered what the consequences of a unification of supervisory regulation would be, and whether a more centralised structure could create risks for the individual credit institution, for example due to a shift of the focus of supervisors to a more group-wide perspective?

Further, I would like to add that the new Lamfalussy-committees have only recently been established in order to address exactly the identified regulatory/supervisory challenges, and they should now be given the possibility to work. For example, in the paper it is noted that Basel II contains a high number of discretions, and that these discretions carry the possibility that standards will be differently applied across Member States. In the last months, CEBS – the Committee of European Banking Supervisors – has worked on this issue and put forward a proposal for deletion of some of these discretions to the Dutch Presidency and the Commission; further, CEBS will try to enhance convergence in the exercise of the remaining supervisory discretions. Another example mentioned in the paper is reporting: Here, CEBS will soon start a consultation process to achieve a common solvency ratio reporting framework under the Basel II framework. Moreover, as regards the issue of information exchange, CEBS' mandate explicitly states that CEBS has to promote supervisory co-operation, including through the exchange of information; finally, concerning cross-sectoral issues, the three level 3 committees have already established arrangements for close co-operation.

It is also important to keep in mind that work on consistent implementation of community legislation and supervisory convergence, which is the core mandate of CEBS, is in any case a precondition for further centralisation, irrespective of any final solution. At the same time, the current system would have the advantage that it still allows taking into account national specificities where required. Finally, if the system works appropriately, I see no urgent need for any changes. In the paper, it was also clearly expressed that the ability of these present arrangements to cope with the current challenges will influence the debate on the need and timing for institutional reform.

Some kind of European Supervisory Authority seems – from my perspective – in principle possible, but – and this is important – only in a long term perspective and only, if a number of preconditions are met:

There has to be enhanced financial market and political integration.

A number of accompanying measures have to be taken, e.g. as regards accountability arrangements, crisis management, changes in national administrative laws, etc.

In order to ensure that supervisors receive all the required information, only a decentralised organisation seems possible.

A European Supervisory Authority should be competent for the supervision of all institutions, irrespective of whether they carry out cross-border activities or not.

As regards the scope of such an authority, I personally think that it would – at least in a first step – have to be created on a sectoral basis (European Banking Supervisory Authority).

4. Crisis Management

At this point I turn very briefly to the issue of crisis management: The Memorandum of Understanding between central banks and banking supervisors on crisis management, which is a very valuable tool in this respect, has already been mentioned. It also seems to be worth mentioning that the European Commission's proposal for a capital requirements directive (*Basel II*) contains in addition a provision that aims at ensuring appropriate information not only of (non-supervisory) central banks, but also of finance ministries.

In particular, the paper addressed deposit insurance and lender of last resort issues: Based on an EC directive, deposit insurance is organised on national level, in principle on basis of the home-country principle, with the possibility for branches to top up in the host country. This implies, as pointed out in the paper, some questions in the case of a major restructuring of subsidiaries into branches. Depending on future developments it could also be necessary to address the fact that deposit insurance schemes are still quite different within the EU.

The relevant European institutions and fora are aware of these issues, and also of questions related to the lender of last resort function (in a wider sense). As regards the latter, basically three issues have to be addressed: first, the arrangements for emergency liquidity assistance provided by central banks in exceptional cases and second, the use of tax-payers' money, or more generally the conditions under which a Member State provides financial aid. These arrangements have to be a bit *ambiguous* in order to avoid moral hazard effects; third, the interplay between supervisory authorities, central banks and finance ministries, which has to be flexible in order to appropriately address and cover the different potential crisis situations.

5. Conclusions

The objective of the presented paper is to contribute to the search for a consensus. From my point of view, this objective has been met without doubt, even though it is clear that the raised issues will require further consideration over the next years.