Supervising the European Financial System

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In July 2000, a CEPS working party on "Challenges to the structure of financial supervision in the EU" concluded that the home country control principle would remain the basis for financial supervision in the EU, but that supervisory cooperation needed to be strengthened further at European level. Because of the decentralised structure of the EU and its ongoing heterogeneity, an integrated European financial supervisor was not seen to be the solution to deal with growing market integration. However, this should not stop policy makers from further streamlining the structure for European supervisory cooperation, as well within as across sectors.

The debate has in the meantime become more complex. While supervisory cooperation has undoubtedly further improved, both within and across sectors, it has become clear that a solution for the European context will need to be specific and tailor-made. A few examples may be sufficient to emphasise the complexity of the problem.

- The final report of the Lamfalussy Committee on the regulation of European securities markets (February 2001) stated that, in case of no progress on the basis of its proposals, the creation of a single EU regulatory authority for financial services in general should be considered;
- In a statement on the role of central banks in prudential supervision (April 2001), the European Central Bank (ECB) strongly supported extensive supervisory responsibilities of the national central banks in the Eurosystem;
- In the discussions on the revision of the investment services directive (July 2001), the European Commission proposed to move to supervision by the country of origin/establishment (which is not necessarily the home country), as is also provided for in the e-commerce directive;
- In a statement on the consolidation of central counterparty clearing (September 2001), the ECB insisted on the role of the Eurosystem in setting risk management standards of such systems, because of the systemic dimension. The ECB also indicated that, for the same reasons, any "domestic" market infrastructure for securities and derivatives denominated in euro should be located in the euro area.

Europe's financial markets are in a state of transition from a high degree of fragmentation and state protection to becoming more integrated. In these circumstances, the different interested parties are trying to adapt and redefine their roles. The main actors are the national supervisory authorities, the European central bank and the European Commission, the financial institutions and the securities markets. The issues are role of the central banks, and the ECB, in financial supervision, integrated versus specialised financial supervision, the continuing relevance of the home country control principle and the adequacy of supervisory cooperation.

The purpose of this paper is to address the problems in reforming the structure of financial supervision in the EU and discuss the challenges, as seen from the point of view of supervisors as well as from the supervised. After reviewing the current models and structure of financial supervision, and the form of European regulatory

and supervisory cooperation, we will address the shortcomings in view of continuing market integration and the possible remedies.

I. Financial Supervision: current models and structure

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

In the meantime, the main change has been the gradual erosion of central banks' involvement in banking supervision. The predominant view is that central banking is about maintaining price stability, as was also laid down in the Maastricht Treaty. Involvement in banking supervision may create conflicts of interest with the price stability mandate of the central bank. Finance has also become more and more complex, and crossing the traditional sectoral borders of the industry, leading to the view that integrated financial services authorities may be better adapted. In these circumstances, the exercise of banking supervision under roof of the central bank was seen as a barrier towards a more overall integrated supervision of the financial sector as a whole.

The first integrated financial supervisory authorities were created in the early 1990s in the Nordic countries. The first was Norway, which integrated bank and insurance supervision in 1986, followed by Denmark in 1988 and Sweden in 1992. The most exemplified, however, was the creation of the UK Financial Services Authority (FSA) in May 1997, an integrated financial supervisor, which regrouped 7 different financial sector supervisory authorities.[2] The creation of a German FSA is also close to be agreed, although some important exceptions remain, such as the supervision of securities markets, which remains in the hands of the *Länder*.

The advantages of an integrated financial supervisory authority, as compared to specialist supervisors, are not very clearcut. Although it may seem obvious that integrated authorities is the most adapted to the evolutions in the financial sector, the first question that needs to be answered is: what is financial supervision about, and what structure fits best to meet these objectives?

Financial supervision is about protecting consumers and ensuring the stability of the financial system. At first sight, an integrated or specialist supervisory authority would

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[1] The control of brokers and investment funds, securities settlement systems, listing procedures and securities markets may, in the extreme case, be spread over different authorities, as is, for example, the case in Germany. See for an overview Lannoo (2001), p. 44.

[2] The FSA has rule-making powers and is accountable to the government and Parliament. The Bank of England remains responsible for ensuring the overall stability of the financial system. The Bank would be the vehicle for lender-of-last-resort operations, if any, informing the Chancellor of the Exchequer, with the possibility then of an override by the Treasury. A Memorandum of Understanding between the Treasury, the Bank of England and the FSA sets out the respective responsibilities of the different bodies.

not make much difference. It would be a matter of balancing the advantages of the different models in view of the policy priorities. A specialist authority can be better aware of and more specialised in the sector and products it supervises, whereas an integrated supervisory authority may ensure more streamlined supervision and better oversight of integrated financial groups. A schematic comparison of the main advantages of both models is given in Table 1.

An integrated authority is seen to generate economies of scale (and probably economies of scope) in supervision, as well as some practical and political advantages. It offers one-stop shopping for authorisations of conglomerate financial groups and eliminates any confusion over who exercises lead supervision and final control. Expertise is pooled and cooperation between the different functional supervisors is guaranteed. Unnecessary overlaps are avoided and support services such as personnel, administration and documentation can be merged. An integrated authority should thus lead to lower supervisory fees, at least in these countries where the financial sector contributes directly to the cost of supervision, and to a lower cost of supervision in general.

An integrated supervisor will however only be effective in supervision if it is more than a combination of divisions, and if synergies can be exploited. It has been argued that the crucial thing is not whether all the functional supervisors are under a single roof, but whether they communicate with one another. This is certainly not a simple task, if one imagines that the British FSA employs about 2000 persons. If an integrated supervisor is no more than a combination of banking, insurance and investment business divisions, the full benefits of a single regulatory authority will not be achieved.

Financial supervision is also about avoiding to give the wrong signals. In this sense, an important argument against an integrated supervisor is its higher profile. A Leviathan supervisor could create the perception that the whole financial sector is secure. It may reduce the incentives for providers to prudently manage their business, and for users to carefully choose their financial services' provider, the so-called moral hazard. It could also be argued that the failure of one institution would have more widespread effects in a combined regime, because the effectiveness of supervision of the whole financial sector would be put into question.

The advantages of a specialist supervisor are its lower profile and a clearer focus on the sector and/or objective of supervision. It could allow for a greater proximity to smaller firms, on which a single regulator may be less inclined to focus, more specialisation, and better awareness of the problems of the sector. Two arguments stand out: a growing need for specialisation in supervision and inter-agency competition. Very distinct skills are required from supervisors, ranging from monitoring potentially dangerous exposures in increasingly globalised financial markets and validating statistical models in a bank's internal ratings models to supervising complex financial groups or tracking market behaviour of investment funds. It is an open question whether a single regulator can do this better than specialist supervisors.

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

supervisory models to attract business. This consideration has also played a role in the creation of the UK's FSA.

Table 1. Comparative advantages of the dominant models in financial supervision

Integrated financial supervisor	Specialist supervisor
• One-stop shopping for authorisations, and (possibly) a single rule book • Adapted to evolution in financial sector towards more complex financial products and financial conglomerates • Eases cooperation between sectoral supervisors; one lead supervisor or a single supervisory team for conglomerates • Can reduce regulatory arbitrage and deliver regulatory neutrality • Pooling of expertise and economies of scale (certain units could be merged, e.g. authorisations, support services) • Lower supervisory fees • More transparent to consumers	• Lower profile • Clearly defined mandate • Easier to manage • Better adapted to the differences in risk profiles and nature of the respective financial business (e.g. retail versus wholesale), clear focus on objectives and rationale of regulation • Closer to the business (but not necessarily) • Better knowledge of the business, more specialisation • Stimulates inter-agency competition

An outcome of the conglomeration trend, and of the undecided debate of single versus specialised supervisors, is that supervision may become more objective-driven. Since the functional divisions of the business will be increasingly difficult to make, authorities will look at another way to supervise the financial sector efficiently. One possible model calls for one agency to carry out surveillance separately for systemic stability reasons, a second for prudential supervision and a third for conduct-of-business. Conduct-of-business supervision looks after transparency, disclosure, fair and honest practices, and equality of market participants. The "stability" agency should concentrate on macro-prudential problems, which affect the conduct of monetary policy or overall financial stability, while the prudential agency controls the solvency and soundness of individual financial institutions and enforces depositor and investor protection.

Such a horizontal supervisory structure was instituted in Australia, further to the Wallis Committee of Inquiry in 1997. The Australian Prudential Regulatory Authority (APRA) supervises financial institutions on prudential grounds; the Reserve Bank of Australia looks after systemic stability and provides liquidity assistance; and the Australian Securities and Investment Commission (ASIC) controls market integrity and conduct-of-business rules. Several EU countries have elements of an objective-driven system of supervision, mainly as far as the relationship between the banking and the securities supervisor is concerned. In Italy, for example, banks and securities houses are controlled by the Banca d'Italia on financial stability and prudential grounds and by CONSOB for conduct-of-business reasons. A similar model is to be introduced in the Netherlands in the course of 2002, where conduct of business supervision for the whole financial sector will come under a newly created Authority for Financial Markets. At prudential level, the central bank and the insurance supervisor will integrate supervision for cross-sector activities (see Jonk, et al., 2001).

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

II. European regulatory and supervisory cooperation

European regulatory and supervisory cooperation is more elaborate than one would at first sight think. All EU single passport directives for the financial sector also provide for a structure of cooperation among national *regulators*. Moreover, a structure is also in place to discuss cross-border *supervisory* issues. Two questions need to be addressed in view of growing financial market integration: 1) the appropriateness of the home country control principle, and 2) the relevance of the current structure of European regulatory and supervisory cooperation.

A. The home country control principle

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

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

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

The discussion above about single versus specialised financial authorities has indicated that the answer is not so easy, however. From a supervisory perspective, a European FSA would exacerbate the disadvantages of a single regulator at national level, as discussed above. From a regulatory point of view, it would be difficult to reconcile with the basic principles of the single market, whereby only essential rules are harmonised, and the rest is left to adjust in a competitive process between jurisdictions. In this sense, it is certainly not proven that a single authority would improve supervisory efficiency, as it would eliminate this competitive process. Moreover, a single EU supervisor would lead to important legal problems for areas

that have not been fully harmonised at EU level. Would a European supervised group fall under the single regulator for some aspects of its business, whereas others would fall under national law?

Also politically, it would be difficult to argue for a single supervisory authority, as it will have to be proven that financial supervision can be better executed at federal than at national level, leading in a second step to a Treaty change to create such a body.[3] Moreover, financial supervision implies accountability and tax powers for eventual bail-outs. While the former could be dealt with, the latter would be much more difficult, and would entail explicit agreement between member states for burden-sharing or bail-outs. Finally, smaller banks (and member states) may see a single regulator, and even more a dual framework, as a competitive distortion.

B. European supervisory cooperation

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

A Memorandum of Understanding (MoU) is a form of agreement between supervisors, which has no legal force, but sets out the respective tasks and obligations of both parties. In principle, the EU directives make formal agreements between supervisory authorities of the member states superfluous, since they make cooperation a legal obligation. In practice, supervisors have continued to conclude MoUs to clarify what is involved in the supervision of financial institutions and markets, such as information exchange and mutual assistance, establishment procedures and on-site examinations. In banking, some 78 bilateral MoUs had been signed between EEA banking supervisors by the end of 1997 (Padoa-Schioppa, 1999), while there is a multilateral Protocol to the Insurance Directives which serves as an MoU, and the EEA securities commissions have, in the context of FESCO, also signed a multilateral MoU in relation to exchange of information for market surveillance purposes.

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

Information exchange is even more important in crisis situations. However, EU directives do not impose an obligation for information sharing in times of crisis. A recent report of the EU's Economic and Financial Committee (2001) thus

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[3] As would be required for a European Securities and Exchange Commission (SEC), a single banking regulator or a European FSA. It has been suggested that the ECB might assume the role of single banking regulator without a Treaty change, but it should be noted that Art. 105.6 of the EU Treaty reads: "The Council may (…) confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings", only refers to "specific tasks concerning policies", not to day-to-day supervision, in which case a Treaty change would also be required.

recommended that MoUs should be further developed to make them more concrete with respect to crisis management. The report suggested that this can best be done in the context of the several committees that exist at European level.

Several committees have been in place at EU level to promote cooperation between regulatory and supervisory authorities. Most of them were created with the start of European integration in the area. Their principal tasks are to:

1. Provide a forum for the exchange of views and to act as a sounding board for the Commission on any proposals for supplements or amendments to legislation;
2. Discuss and adopt technical adaptations to the directives within the perimeters foreseen in the directives (the "comitology" procedure); and
3. Discuss and compare issues of supervisory technique and to facilitate the exchange of information and cooperation with respect to problems with individual institutions.

This is, however, a general characterisation, which varies between the sectors of financial services. The committees are most developed in banking. The highest number of committees exists for securities markets, but with the least powers (at least until very recently). A schematic overview is given in Table 3, where we distinguish between Committees dealing with regulatory, supervisory and financial stability matters. This distinction is to a certain extent arbitrary, since the tasks of the different Committees are often not as clearcut.

In banking, three committees are in place. The **Banking Advisory Committee** (BAC) principally advises the European Commission with regard to policy issues in the formulation and implementation of EC legislation for the banking sector. It can also, if foreseen by the directives, agree on technical adaptations to the directives (the "comitology" procedure). In order to do this, it brings together senior supervisory and finance ministry officials. The **Groupe de Contact**, which consists only of banking supervisors of the European Economic Area (EEA), has dealt for nearly 30 years with issues of bank supervisory policy and practice including the carrying out of comparative studies, arranging the exchange of information and handling cooperation with respect to issues arising from individual institutions. The **Banking Supervisory Committee** of the **ECB** brings together the banking supervisors to discuss macro-prudential and financial stability issues of all the EU countries, thus not only the eurozone. It also assists the ECB in the preparation of the ECB's advice on draft EU and national banking legislation (within euro area countries) as laid down in Art. 105(4) of the EU Treaty and Art. 25(1) of the ESCB/ECB Statute.

In response to criticism on the lack of macro-prudential oversight in the EU, the ECB's has recently explicitly indicated that its Banking Supervisory Committee will also perform that role (Meister, 2000; EFC, 2001:p.7). During the Russian crisis in 1998, it had appeared that European banks had large exposures to emerging markets, whereas no body was monitoring this from a European perspective. Such a situation could in EMU no longer happen, as financial crisis could rapidly spill-over from one market to another via the inter-bank market. It was therefore proposed to create a European Observatory of Systemic Risk (ESFRC, 1998).

In insurance, the BAC is broadly paralleled by the **Insurance Committee** and the Groupe de Contact by the **Conference of Insurance Supervisors**.

In the securities field, there was, strictly speaking, until recently no parallel structure to the legislative committees existing in the banking and insurance field. There ware some Committees, but they had only a consultative function, and lacked seniority. A first reaction was the creation of FESCO in 1997, but this happened outside the EU context, as an intergovernmental consultative body. The Lamfalussy Committee

discussed this situation at length, in the context of the need to adapt legislation rapidly to changing market circumstances. It proposed a four level approach as model for securities market legislation, but also for financial services legislation in general, consisting of:

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

Decisions towards the creation of the **Securities Committee** and the **Committee of European Securities Regulators (CESR)** were taken by the European Commission in June 2001. The Charter of CESR was adopted in September. But the Securities Committee will only have "comitology" powers once the new 'Lamfalussy style' securities markets directives have been adopted by the EU Council and European Parliament, and this has not been without problems. Since the formal launch of the Lamfalussy report, the European Parliament has opposed the granting of greater powers to a Securities Committee, which would be secretive and unaccountable, it argued. Moreover, the European Parliament may have different views on what is part of framework legislation and what is technical detail. Details regarding investor protection, for example, may be seen as a technical detail for the regulators, but essential for the European Parliament. A compromise proposal in now underway which will, at least temporarily, accommodate the wishes of the European Parliament, and allow the Securities Committee to function as foreseen in the Lamfalussy report.

From a sectoral perspective, the framework for regulatory and supervisory cooperation in the financial services sector could be considered as complete since the adoption of the Lamfalussy report. The structure has also become more complete as regards cross-sectoral matters. In 1999, a **Mixed Technical Group on Financial Conglomerates** was created to discuss cross-sectoral regulatory matters. In response to the recommendations of the Brouwer report (European Commission, 2000), a **Cross-Sectoral Roundtable of Regulators** was set up to promote exchange of information among supervisors. For conglomerates specifically, a new draft directive on financial conglomerates (April 2001) provides for mandatory appointment of one or more supervisory co-ordinators for any conglomerate that falls within the scope of the directive. The draft directive lays down the specific tasks of the co-ordinator of each financial conglomerate, such as the assessment of the financial situation of the group, the assessment of the financial conglomerates structure, organisation and internal control systems (Art. 7).[4]

Regulators have also taken initiatives to cover specific areas in the financial sector. In April 2001, the ECB announced the conclusion of an MoU between payment systems overseers and banking supervisors in EMU, because of the financial stability dimension. In October, the ECB also announced joint work with CESR on issues of

[4] Proposal for a directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM(2001)213 of 24.4.01.

common interest in the field of securities clearing and settlement systems, with the intention establishing of standards for securities settlement systems and central counterparties.

This overview would be incomplete without a brief mention of the Financial Services Policy Group (FSPG) and the Economic and Financial Committee (EFC), although they are strictly speaking not part of the for a for financial supervision. The FSPG was set up by Commissioner Monti in 1998 as part of the effort to re-launch the internal market for financial services in the FSAP. Its main purpose is to set strategic directions for the financial regulation in the EU. It brings together finance ministry officials and other high-level civil servants. The EFC on the other hand discusses macro-prudential issues related to EMU. There is thus clearly no lack of multilateral fora for regular consultation among the EU member states.

III. Challenges to adequate regulation and supervision

Most of the challenges to adequate regulation and supervision in the EU have been on the policy agendas since the start of EMU, or even earlier, but have not become less pressing in the meantime. They concern the need for a stricter enforcement of rules, the need to open-up retail financial markets and the problem of crisis management in the EU. Some new problems have emerged: it concerns the implementation of the Basel II and the adequate supervision of securities markets.

- <u>Stricter enforcement of rules</u>

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

An issue, which is often overlooked is the role self-regulation and disclosure can play in enforcement. The European Commission is now trying to promote the use of ombudsmen at national level to ease the resolution of conflicts between providers and consumers of financial services. In securities markets, however, the role of self-regulation was almost absent in the Lamfalussy report, while it plays a very important role. Reputational intermediaries, such as investment banks, law firms, rating agents, play an important role in improving the standards in securities markets regulation, as well as standards setters such as accounting standards boards and professional federations.

The problem of enforcement will not become lesser in the years to come, as the EU intends soon to enlarge with 12 new member states, 10 of which may join in 2004! All applicant states need to have transposed all applicable EU legislation in national law by the day of entry, or they need to negotiate transition periods to the full application of specific elements of legislation. The applicant states are well advanced in this process of approximation of laws, although problems with effective enforcement may only appear at a later stage, and will undoubtedly become bigger in an EU of 27.

- <u>The need to open-up consumer financial markets</u>

The lack of integration of consumer financial markets is an old problem, which does not seem to come much closer to a solution. The core of the problem is the difficult interaction of financial market legislation, which liberalise market access under the control of the home country and minimal harmonisation of rules, and the consumer

protection legislation, which falls largely of the member states, and requires maximal harmonisation to allow market integration. Consumer protection legislation is however so vast that EU attempts to harmonise will always somewhere fall short, allowing member states to argue that a product sold on a cross-border basis by a firm of another member state falls short of the host states consumer protection rules. The way out of this eternal dilemma is to require member states to recognise each other systems as equivalent, and set a sunset clause for the application of host country rules in harmonising measures.

An example of this difficult interaction are the e-commerce directive and the draft distance selling of financial services directive. The former directive, adopted in 2000, enables on-line providers to supply services throughout the EU based on the rules of the country from which the provider effectively carries out his activities - also called the country of origin (not necessarily the home country).[5] However, the directive excludes amongst others financial services contracts and host country measures which are needed to protect consumers. The applicable rules for the latter should be defined in the distance selling of financial services directive, on which a political agreement was reached in September 2001. This directive defines in much detail the information to be supplied to consumers before the conclusion of a contract, the form of contract, the financial services covered, the right of withdrawal (with a cooling-of period of 14 to 30 days), and the settlement of disputes. Article 13 of the directives states that member states can impose additional rules on providers from countries where the distance marketing directive has not been properly implemented, which in practice overrules the country of origin rules of the e-commerce directive. Some countries have therefore called for a clause in the distance selling directive to ensure that in case of disagreement, the e-commerce directive rules would apply.

- Systemic risk and crisis management

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

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

On the eurozone-EU dimension, the ECB has been more pronounced. Its role is limited to the eurozone, and the coordination at EU level is weaker than it is at eurozone level. Is the risk also lesser? On the other hand, the ECB has clearly indicated that central counterparties in securities clearing should be located in the eurozone, because of the systemic dimension (ECB, 2001b). However, its role is limited to payment systems, it has strictu sensu no responsibility for securities clearing.

Three years after the start of EMU, the ambiguity regarding crisis management remains. This point has been raised by many academic commentators, but also at official level, in the Brouwer reports. The ambiguity about procedures and responsibilities is not seen as constructive, as it reduces confidence, accountability,

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[5] The country of origin rules have also been proposed for the application of conduct of business rules in a communication on the revision of the EU's investment services directive, see European Commission (2001).

and possibly the effectiveness of crisis management. The current system is seen as one of 'improvised co-operation'. If ever a failure of a financial institution with European-wide dimension happens, it is likely that supervisors and national states will have rows over who is responsible and who pays. The second Brouwer Report has tried to meet these concerns by requesting national supervisory authorities to add procedures for crisis management to the bilateral Memoranda of Understanding. It also called for removing remaining legal impediments to the exchange of information among supervisors. But, for the remainder, the ambiguity remains.

- <u>The implementation of the Basel Review</u>

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

Basel II will become a complex EU directive, this can already be said with certainty now. The level of technical detail in Basel II is high, which raises the question about the handling of the directive by the European Commission, the processing of the directive by the European Parliament and the EU Council, and its implementation in national law. The positions of different interest groups vis-à-vis Basel are high, which predicts a difficult decision process and an uncertain outcome.

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

The convergence of supervisory practices is another priority. However, it is the question whether pillar II of the Basel Review, whereby authorities can determine when to intervene with a bank in trouble, is an excuse for national authorities to keep supervisory practices un-coordinated. Finally, regarding the proposal for increased disclosure under pillar III of the accord, this practice is still infrequent and underdeveloped in Europe. The number of listed banks issuing half-yearly accounts in the euro area is less than half of that in the US (Enria and Vesala, 2001). Disclosure furthermore raises the problem of differences in accounting conventions.

- <u>Adequate regulation and monitoring of securities markets</u>

Most works remains to be done to improve the regulation of EU securities markets and to further harmonise rules. This is commonly accepted since the adoption of the Lamfalussy report. However, whether the outcome of this exercise will be a more harmonised and workable regulatory environment as another matter, as the reactions to the new draft directives have to be proven. The draft prospectus rules were seen as unworkable, the market manipulation directive undesired, and the proposals for revision of the investment services directive too extensive. The markets seem not too be willing to see that a tighter regulatory framework is needed to allow European capital markets to move to a higher gear. Moreover, there is the problem with the European Parliament on comitology, as referred to above. The upshot of all this is that the regulatory framework will be in place later than predicted, and that it may not be as streamlined as intended.

IV. Conclusion: A model for Europe?

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

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

At the level of prudential supervision, the structure of cooperation is in place, but much works remains to be done. There is the streamlining of the home country principle, upgrading of the memoranda of understanding and the improvement of the mechanisms and quality of information exchange. The biggest issue, however, is the standardisation of the supervisory practices in the EU, where work still has to begin. The outcome of the Basel Review, and in particular its pillar II should also indicate how this work will be taken forward.

At the level of conduct of business rules, there is probably the least need for harmonisation, but at the same time the most opportunity for member states to protect national markets on the basis of many pretexts. A commonly agreed solution for the interaction of market liberalisation and consumer protection rules at a general level would be most desired.

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Table 2. Supervisors of banking, securities and insurance in Europe, Japan and the US (2001)

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

Note: CB = Central Bank, BS = banking and securities supervisor, FSA = single financial supervisory authority, B = specialised banking supervisor, S = specialised securities supervisor, I = specialised insurance supervisor, SI = specialised securities and insurance supervisor, G= government department. The supervision of securities markets is a generalisation of the most prevalent model in a certain state; it does not take the spread of the different aspects of supervision over different authorities into account.

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

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

ANNEX
EU AND EEA FORA FOR COOPERATION IN FINANCIAL SUPERVISION

1. Banking

1. Banking Advisory Committee (BAC)

- Established in 1977 by the First Banking Coordination Directive.
- Threefold role: 1) assists the European Commission in drawing up new proposals for banking legislation, 2) helps to ensure adequate implementation, and 3) serves as the "regulatory committee" under the so-called "comitology" procedures for technical amendments to EC banking legislation. The latter are changes that can be made outside the normal legislative procedure.
- Consists of high-level officials from finance ministries, central banks and supervisory authorities of the member states and from the Commission, with a maximum of three representatives per national delegation; officials from other EEA countries and the ECB participate as observers; the chairman of the Groupe de Contact also attends.
- Chairman is chosen for a three-year period from representatives of member states, secretarial services are provided by the European Commission.
- Meets three to four times a year.
- Discussions are confidential, but a tri-annual report is published by the chairman.
- When committee acts as "regulatory committee", it is chaired by the European Commission.
- Does not consider specific problems related to individual credit institutions.

2. Groupe de Contact (established 1972)

- Set up by banking supervisors of EEA member states on a cooperative basis.
- Deals with micro-prudential cooperation, including information-sharing both in general and in particular cases, and carries out comparative studies on policies and techniques of supervision. It also assembles, as required under the banking directives, various EEA-wide statistical services including on solvency, profitability and liquidity.
- Consists of one official from each banking supervisory authority in the EEA; an official from the Commission also attends as adviser on legal issues but does not attend discussions dealing either with individual firms or sensitive supervisory assessments.

3. Banking Supervision Committee of the ECB (established 1998)

- Succeeded Subcommittee on Banking Supervision of the European Monetary Institute, which had originally been created in 1990 as the Banking Supervisory Subcommittee of the Committee of Governors of the EC Central Banks.
- Assists the ESCB with regard to policy issues in the area of macro-prudential supervision, i.e. the stability of financial institutions and markets, and in preparing ECB opinions on legislation as provided for under the Treaty.
- Consists of high-level officials from all central banks and non-central bank supervisory authorities in member states plus ECB officials; Commission officials participate as observers.

Duplication of work is avoided through regular informal coordination meetings between chairmen of each of the three committees dealing with banking supervisory matters.

2. Securities markets

4. Contact Committee (established 1979).

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

5. UCITS Contact Committee (established 1985)

- Advisory committee, without comitology role.
- Facilitates harmonised implementation and advises the Commission on any amendments to the 1985 UCITS directive (unit trusts directive).

6. High-Level Committee of Securities Market Supervisors (established 1985)

- Strategic committee, meets 2 to 3 times a year at the initiative of the European Commission.
- No formal legal basis, functions as Commission working group until Securities Committee is formally established by an EU directive.
- Advises the European Commission on regulatory and supervisory matters.

7. CESR, formerly FESCO (established December 1997)

- Originates from Informal Group of Chairmen of EU Securities Commissions.
- Brings together securities commissions of the EU. Functioned originally on an intergovernmental basis and with delegates from the European Economic Area (the EU, Iceland and Norway, in the context of the Forum of European Securities Commissions, FESCO).
- Aims to enhance the exchange of information between national securities commissions, to provide the broadest possible mutual assistance to enhance market surveillance and effective enforcement, to enhance uniform implementation of EU directives and to develop common regulatory standards in areas that are not harmonised by European directives.
- Formally established as the Committee of European Securities Regulators (CESR) as further to the Lamfalussy report. The Charter was adopted on 11 September 2001. It will function as fully independent Committee with its own secretariat.

8. Securities Committee (established September 2001)

- High-level committee with implementing powers for directives to be adopted as further to the Lamfalussy report
- Was rejected twice before because of procedural problems and sensitivity of European Parliament to “comitology”.
- Relaunched in the Commission’s financial services action plan (May 1999), formal decision taken in June 2001.
- First meeting under the chairmanship of Bolkestein in September 2001.

3. Insurance

9. Insurance Committee (established 1992)

- Assists the European Commission with regard to policy issues in the formulation and implementation of EC legislation for the insurance sector, consultative role for new Commission proposals.
- Consists of high-level officials from finance ministries and supervisory authorities of the member states plus Commission officials; officials from other EEA countries participate as observers.
- Serves as "regulatory committee" under the so-called "comitology" procedures for technical amendments to EC insurance legislation (life and non-life insurance).
- Does not consider specific problems related to individual insurance undertakings

10. Conference of Insurance Supervisory Authorities of the EU (established 1958)

- Forum for debate among EU supervisors on micro-prudential issues relating to individual insurance undertakings.
- Agreed on 'protocols', a form of multilateral memorandum of understanding between insurance supervisors, to deal with supervisory problems.
- Composed of 15 EU states and 3 EEA countries, with European Commission as observer (no formal link with EU).
- Meets twice a year

4. Cross-sector fora

11. Commission Mixed Technical Group on Financial Conglomerates

- Established in 1999, involving representatives of the sectoral regulatory committees.
- Considers information sharing between supervisors and co-ordination of prudential supervision on a cross-sectoral and cross-border basis, capital adequacy at group level and intra-group transactions.

12. Cross-Sectoral Roundtable of Regulators

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

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