Regulation and Supervision of Financial Markets and Institutions

A European Perspective

Andreas Grünbichler and Patrick Darlap

July 2003

Andreas Grünbichler is Executive Director of the Austrian Financial Market Authority (FMA), Patrick Darlap is his assistant. The authors wish to thank Howard Davies, Graham Bishop, Heinz Hauser and Rico von Wyss for their helpful comments. All remaining errors remain our own.

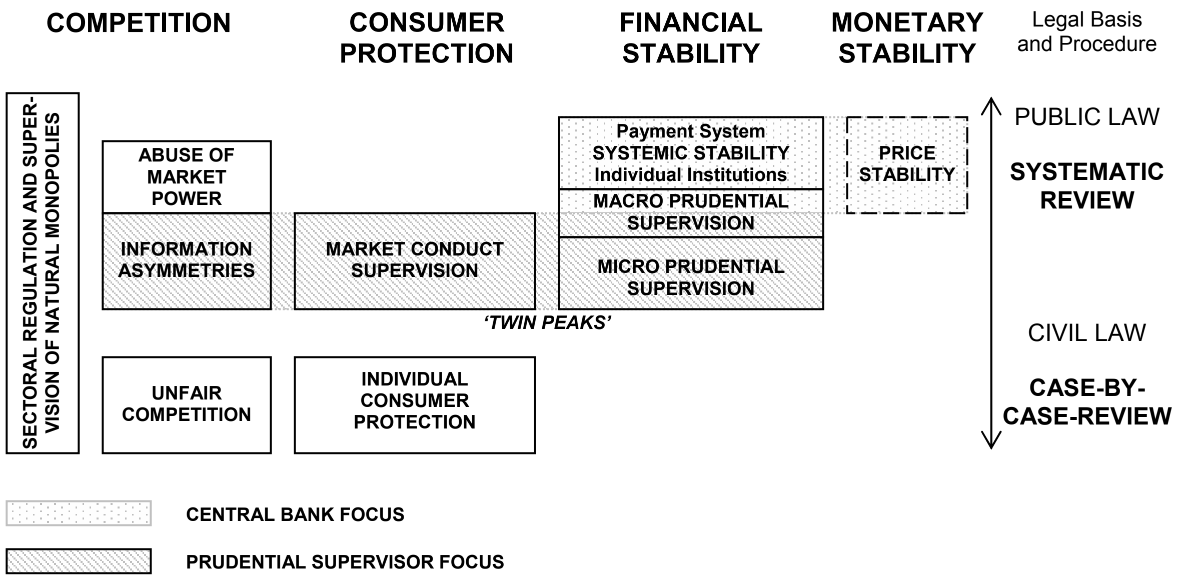
Correspondence: Prof. Dr. Andreas Grünbichler, Austrian Financial Market Authority, Praterstrasse 23, 1020 Vienna, Austria, Tel.: +43-24959-6000, Fax +43-24959-6099, e-mail: andreas.grunbichler@fma.gv.at, http://www.fma.gv.at

Introduction

This paper touches upon dualities which can be detected with many aspects around the task of safeguarding financial market stability. Because dualities tend to bring along the necessity to deliminate the one against the other, we try to mark some aspects of the critical points in the separation of responsibilities and of the necessary cooperation among the players in the field of financial market control.

As a first step, we should like to illuminate the wider stage of financial market activities, where financial market stability is one of several aspects of intervention deemed necessary.

Figure 1: **Policy Aspects in Financial Markets**



As can be seen in the figure above, the primary freedom of financial markets may be constrained by financial stability policy as well as by competition policy and consumer protection policy. Within and across these pillars, separate entities may bring their well-defined interests to bear. A strong focus in this paper will thus be on institutional issues.

Financial stability, as one of these pillars, can be broken down into two overlapping fields of interest: Payment system stability and the stability of each individual financial institution.

Monetary stability is not only about money supply and demand, but it is clearly dependant on the functioning and conditions of the transmission mechanisms it makes use of. Central Banks therefore have an interest in the stability of those financial institutions relevant for the payment system. In particular, they are interested in their individual financial condition, too, since it may in return influence their reaction on Central Banks' policies. This makes financial stability an interdisciplinary field.

Besides payment system stability, there is micro stability at the individual institutions' level. It is an invaluable prerequisite to the stability of the sector as a whole through sustained trust of all market participants. For example, it may avoid individually rational decisions to sum up to an economy-wide suboptimal solution, as is best illustrated by the example of bank runs.

The foremost reason for public intervention in financial markets is therefore the positive external effect of a stable financial system on economic development and sustained prosperity. However, the notion of financial stability has changed over the last decades, following the abolition of the Bretton-Woods-System. This new meaning has achieved increasing importance over the past years for the arguments concerning an optimal design of regulatory and supervisory infrastructure in this field.

For the time being, there is no single definition of financial stability. Following a recent suggestion by Issing (2003), a distinction can be made between ‘systems approach’ definitions and those related to the volatility of directly observable financial variables. Crockett (2003) adheres to the first kind, defining financial stability as the unimpaired capacity of financial institutions and markets to efficiently mobilise savings, provide liquidity and allocate investment[1]. It is noteworthy that this definition is tolerating financial institutions’ failures, as long as the functioning of the system as a whole is not affected. But – for the sake of an operationally usable concept – this convincing kind of definition is often replaced by the, more operational, observation of the absence of banking crises, price stability, interest rate smoothness or the like. These definitions often are much more rigid than the systems approach, e.g. stipulating a zero-bankruptcy-goal, which is definitely not in line with the pursuit of market principles and their positive results[2] and furthermore brings along moral hazard risks.

As a consequence of these different possible definitions, the attribution of regulatory and supervisory power to individual institutions and their attribution with conflicting target functions is an ambiguous task and needs careful modelling for an optimal overall economic development. Not only the ‘horizontal’ split of responsibilities is at stake, but also the ‘vertical’ segmentation of tasks along the boundaries indicated in the first figure between prudential supervisors and Central Banks has to be addressed.

Regulation and Supervision

The differentiation between regulatory and supervisory tasks has always been different in practice than theory might have made pure academic thought assume. This has not changed since supervisory tasks were singled out – mostly from Ministries of Finance. There often is no easy differentiation between the regulatory and supervisory tasks of the controlling bodies. The border between both is necessarily blurred due to the fact that supervisors are assigned rule-making powers for refining legislation through ordinances or the like. This aspect may be more or less relevant depending on the legal tradition prevalent in the respective country. In most cases supervisors are (secondary) regulators in that sense besides the institutions creating primary legislation.

Regulation in the financial sector may be designed around three well-known classical topics: financial stability, protection for smaller, less informed clients and thirdly the danger of monopolistic behaviour[3]. But it may be about interest policy and rent seeking as well. There are numerous and antithetical ideas about the rationale of regulation. Depending on how ideal or how real a picture they draw, they are putting different emphasis on what is perceived to be influenced by regulatory action. And vice versa – that is: how regulatory

---

1 See also Mishkin (1991).
2 E.g. the Schumpeterian creative destruction.
3 Stability policy, competition policy and the cure of market failure (e.g. asymmetric information, the abuse of market power etc.) as the main areas of eligible state intervention.

action is influenced by external interests. This discussion is not exactly new and this is not the place to elaborate on the evolution of behavioural theories of regulation. But however old the theory, it is nevertheless an evergreen for understanding the processes around the establishment or refurbishment of regulatory structures.

Supervision is the executive force in financial market control. Supervisors are clearly bound by the legal environment set by the regulators – that is mainly parliament or government, respectively. In addition, supervisors themselves are – more or less and depending on the legal tradition in their respective environment – vested with certain regulatory powers. Crockett (2003) describes them as part of the financial market infrastructure[4]. This 'infrastructure', which financial markets rely on to function properly, includes contract law, law enforcement procedures, accounting practices and valuation standards, prudential regulations, effective supervision, appropriate disclosure requirements and the creation of well-functioning payment and settlement systems. All these fields may be influenced by supervisors in their regulatory role. Thus, of course supervisory bodies are subject to the same problems and therefore may be examined using the same theories as the regulators themselves.

An important piece of work in describing the functioning of regulatory agencies in the sense mentioned before was done by Stigler (1971) and Posner (1974), introducing the self-interest of bureaucratic agents and notionally the idea of a political economy where those interest groups best organised make themselves heard. They did away with the view that 'regulation is instituted primarily for the protection and the benefit of the public at large […]' and asked the seemingly provocative but well-suited question first 'what benefits a state can provide to an industry'. Accordingly, a market for regulation can be construed, where regulation and regulators are instrumentalised by the market incumbents to erect entry barriers and undermine competition.

These considerations make it quite clear that an optimal distribution of responsibilities in the organisation is key to effective and efficient financial market regulation, in particular the different and sometimes necessarily conflicting targets institutions are equipped with in their policy system. 'Ordnungspolitik' has to mark the borderlines of responsibilities and set the stage for well-defined cooperation.

Regulation and Supervision – A National Perspective

We have to be aware that the change in the financial landscape is driven by the twin forces of liberalisation – bringing along the duality of free market forces on the one hand and their regulation on the other - and innovation, e.g. in the forms of derivatives, securitisation and risk transfer.

First we would like to touch upon the institutional setup of supervision, where two kinds of an integrated approach may be adhered to. On the one side, macro- and micro-prudential supervision, i.e. payment system and banking supervision, may be integrated under one roof. As arranged traditionally, these tasks are concentrated at the central bank. However, they

4 It is important to keep in mind that there is empirical evidence of a positive correlation between the legal system and economic performance, as examined by Shleifer (see e.g. La Porta/Lopez de Silanes/Shleifer (1998)) and others e.g. Barth/Caprio/Levine (1998) or Barth/Nolle/Phumiwasana/Yago (2003).

could as well be allocated at the prudential supervisor. On the other side, the integration of the supervision of all financial market intermediaries in an integrated supervisory body is a currently popular policy. The integration of all tasks may be a third alternative. This is, however, a less popular idea due to concerns of an overly accumulation of responsibilities in one single institution. In other words, it is about either the consolidation of macro and micro aspects of monetary and financial stability supervision, or the consolidation of the supervision of all sectors of financial intermediaries – i.e. banks, insurers and all other forms of financial service providers – whether systemically relevant or not.

The twin goals of monetary and financial stability are both public goods having especially to deal with the well-known problems arising under such circumstances, in particular externalities and information deficiencies. These public goods have to be supplied by public institutions, which are described in the different strands of political economy theory mentioned before. The importance of regulatory and supervisory independence can be illuminated by the potential dangers of two kinds of interference often seen as one of the reasons for an insufficient solution of crises in the financial market: political interests and capture by the industry itself, not to speak of the self-interests of regulators or supervisors themselves.

In their analysis of independence, Quintyn and Taylor (2002) distinguish between four dimensions of independence: regulatory, supervisory, institutional and budgetary independence. In the sense of Quintyn and Taylor, regulatory independence stands for the ability of an agency to have an appropriate degree of autonomy in setting (technical) rules and regulations, which may be restrained by political interference to e.g. adapt provisioning rules in order to help an economic sector in trouble. Supervisory independence, on the other hand, is encompassing appropriate salary and legal protection for the individual supervisor, the maintenance of a certain degree of discretion and an effective and efficient legal appeal system. Critical elements of institutional independence are seen to be the terms of employment (appointment and dismissal) of senior personnel, the agency's governance structure and the openness and transparency of decision making.

Not deferring from this view in principle, we rather see only two dimensions along which two variations may be fixed. The first dimension refers to the 'vertical' distance of control operations from the market. The influence of e.g. pressure groups on the regulator may bring about differentiation in the regulatory treatment of sectors or market segments. A (captured) supervisor has to act along these given rules and may be only able to differentiate between individual institutions if urged to.

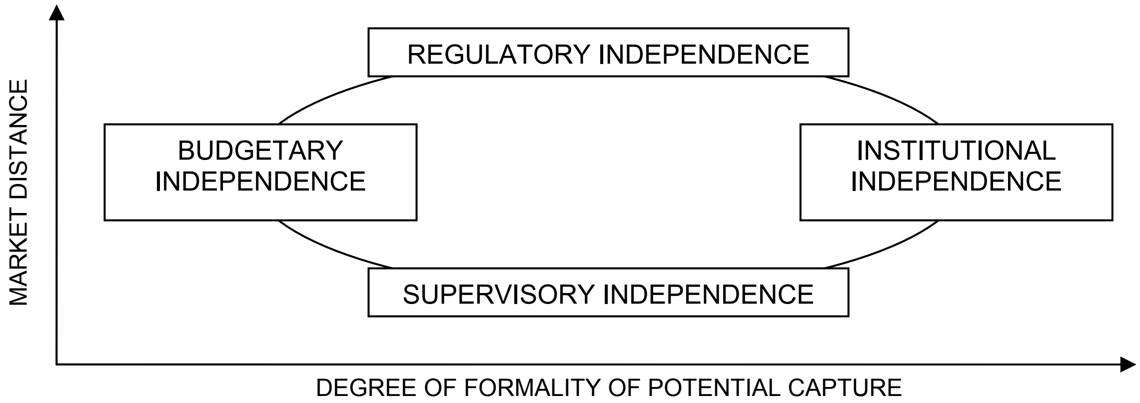
The degree of formality of potential third party influence defines the second dimension. Along this line budgetary constraints or institutional dependence may both, on different formal grounds, affect the decision process of the supervisor.

Even though all these different kinds of independence are highly important, we should like to highlight one particular aspect of supervisory independence. We deem the discretion of a supervisor in individual cases and – related to this – his individual protection.important for the further discussion. A law-based system of sanctions and interventions has the advantage of being more transparent and amenable to judicial review than the exercise of discretion. The leeway for decisions based on factors other than an objective assessment of the technical merits of the case is therefore much reduced. This is opposed to a framework where discretionary space leaves room to move for flexible responses to changes and innovations.

However beneficial such a flexible approach may be, the normative existence of objective parameters may protect the individual supervisor from adverse influences, as for example interest group pressure or the threat of being sued for a decision he made on the grounds of an ambiguous situation.

For the aforementioned reasons, Quintyn and Taylor (2002) see the independence of supervisory bodies as equally important as central bank independence.

Figure 2: **Dimensions of Independence**



Across Europe there is a growing interest on the side of national central banks to play a pivotal role in the supervision of financial institutions. The status of ‘systemically relevant’ institutions affects the stability of the financial system and the smooth functioning of the payments system. To a large extent, the effectiveness of monetary policies is depending in particular on the ability of the sector to react properly to the stimuli at hand of the Central Bank. Policymakers seem to be reluctant to support the central banks’ wishes, however. There is perceived to be an inherent conflict of interest between the target of maintaining price stability and the target of ensuring the solvency of financial institutions. Then, there is always the question of political accountability.

Their knowledge and experience in the field must not be underestimated and doubtlessly is of invaluable help for the establishment of proprietary research in the new integrated supervisory bodies. Nevertheless, there is a number of arguments for and against the separation of banking supervision from the central bank.

First to mention is the conflict of interest between monetary and price stability versus financial stability. Our main concern is that monetary and supervisory decisions will be done better when there is a single focus on each separate task. Neither is the main point that there is a potential reputational risk for the central bank in case of a bank failure. This might harm the credibility of the central bank, which is so important for the conduct of monetary policy and the closely related necessary influence on expectations. We rather see the problem in a central bank having a target function primarily focused on monetary stability.

Of course, there are also strong arguments which favour the unification of the tasks to pursue the twin goals of monetary and financial stability. The necessity for a Central Bank to keep itself informed about the situation of the financial intermediaries, which are part of the monetary transmission mechanism, is undisputed. Nor are the implications of the Central banks' function of being a lender of the last resort, if explicitly established, and the implicated information flows called into question.

The conduct of business-side of supervision – covering to some extent consumer protection – at first glance seems a much easier area to be defined than the prudential questions. When we take a closer look at the tasks of financial supervision on the micro level across sectors, though, different legal objectives can still be identified. In the supervision of banks, for example, consumer protection is only an *a posteriori* goal (with the meta-objective, of course, being the need to safeguard the long-term ability of all banks to fulfil their obligations vis-à-vis their creditors); in the insurance sector the concentration on consumer protection is more clear-cut. This difference will decline as a result of the so called 'Solvency II' exercise in insurance supervision, a process which is all about implementing a sound risk-policy and a risk based capital approach at enterprise-level for insurers parallel to the Basle II methodology for banks. This will bring the regulatory framework of the two sectors closer together, thus making regulatory arbitrage between the sectors less attractive.

Regulation and Supervision – The European Perspective

National supervisory authorities in Europe have been restructuring in the light of new international banking and insurance standards, while the current pan-European framework for financial supervision (notably the future work of European regulators and supervisors in prudential and legislative matters) has become subject to intense discussions.

Taking the national level first, one can see a clear trend in Europe towards integrated financial market regulators and supervisors[5]. Integrated financial supervisors have been established, for example, in Norway, Denmark, Sweden, UK, Germany, and Austria. Sweden's *Finansinspektionen* was established in July 1991 as a reaction to actual and prospective market developments, including increasing integration both among different types of financial institutions and across borders. *Finanstilsynet* (founded 1988) integrates banking, insurance and securities supervision in Denmark, as does *Kredittilsynet* (est. 1986) in Norway. The Austrian *Financial Market Authority* (FMA) was established in April 2002, Germany's *Bundesamt für Finanzdienstleistungen* (BaFin) followed one month later. Singapore finished integration in 1984 (*Monetary Authority of Singapore, MAS*), Japan introduced a single supervisor (*Financial Services Agency*) in June 1998, Australia founded its *Prudential Regulation Authority (APRA)* in July, as did South Korea in April the same year *(Financial Supervisory Service)* and Iceland (*Fjármálaesfirlit*) in January 1999. Already in 1987, Canada merged banking and insurance regulation in the *Office of the Superintendent of Financial Institutions (OSFI)*. In the Accession Countries, Hungary pioneered in April 2000 (*Hungarian Financial Supervisory Authority, HFSA*) with an integrated supervisor, Latvia (*Finance and Capital Market Commission FMC*) followed in 2001, Estonia (*Financial Supervision Authority*) and Malta (*Financial Services Authority*) in 2002. Ireland and Belgium are soon to follow. Consultations to integrate the authorities are underway in Switzerland, Liechtenstein, Greece and Finland.

---

[5] See e.g. Avgerinos (2003), p.332.

Figure 3: **Supervisory Settings in the EU**

	BANKING	INSURANCE	SECURITIES	INVOLVEMENT OF CENTRAL BANK
AUSTRIA	FSA	FSA	FSA	Y
BELGIUM	BSS	IS	BSS	Y
DENMARK	FSA	FSA	FSA	N
FINLAND	BSS	IS	BSS	Y
FRANCE	B/CB	I	S	Y
GERMANY	FSA	FSA	FSA	Y
IRELAND	CB	G	CB	Y
ITALY	CB	I	S	Y
LUXEMBOURG	BS	I	BS	N
NETHERLANDS	CB	I	S	Y
PORTUGAL	CB	I	S	Y
SPAIN	CB	I	S	Y
SWEDEN	FSA	FSA	FSA	Y
UNITED KINGDOM	FSA	FSA	FSA	Y
LIECHTENSTEIN	FSA after reform	FSA after reform	FSA after reform	
SWITZERLAND	BI after reform	BI after reform	S	
NORWAY	FSA	FSA	FSA	
CZECH REPUBLIC	CB/BS	SI	SI	Y
HUNGARY	FSA	FSA	FSA	Y
SLOVENIA	CB	G	S	Y
POLAND	CB	I	S	Y
MALTA	FSA	FSA	FSA	N
CYPRUS	CB	G	S	
LITHUANIA	CB	I	S	Y
LATVIA	FSA	FSA	FSA	N
USA	B/CB	I	S	
JAPAN	FSA	FSA	FSA	

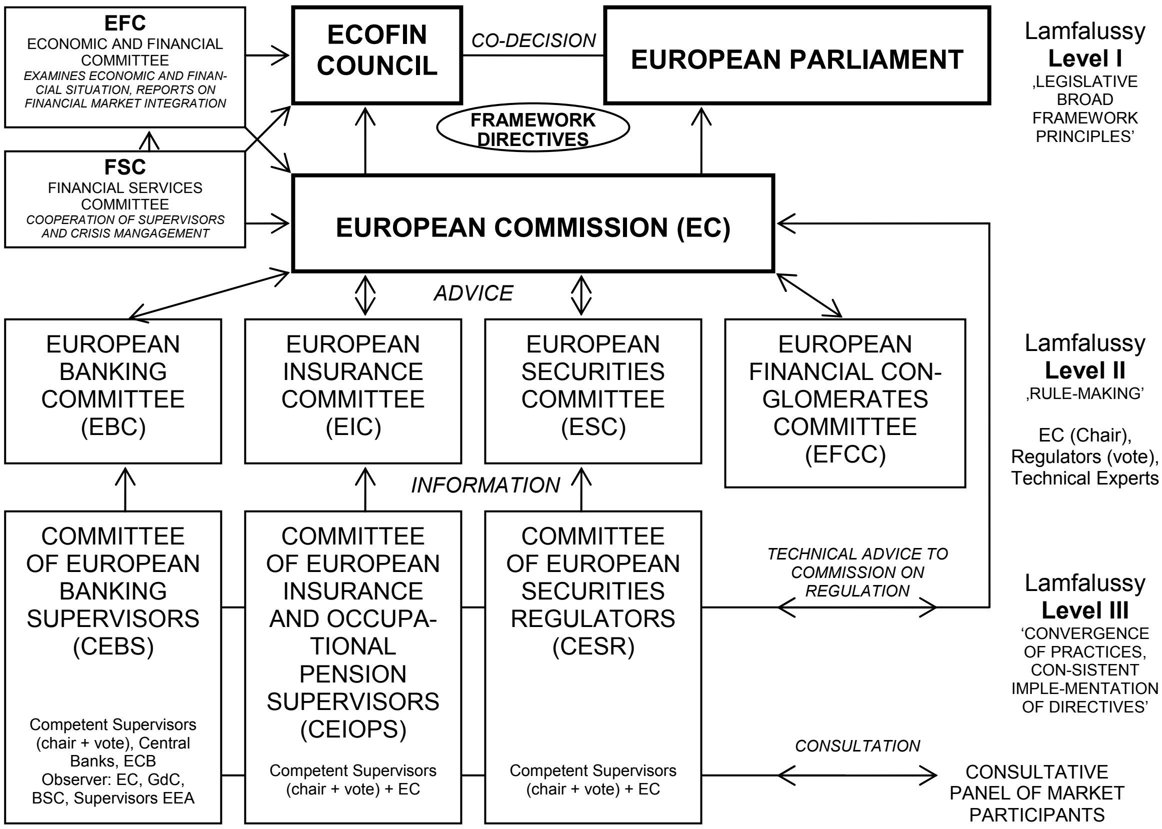
FSA: Integrated Supervisor; CB: Central Bank; B, I, S: specialised banking, insurance, securities supervisor, combinations possible; G: government department.

In summary, supervisory structures in Europe not only have to cope with increasingly blurred sectoral borders; they also have to accommodate a necessary, but in practice not-so-clear, horizontal segmentation of responsibilities. Leaving aside Article 105 of the Maastricht treaty, what is the case for a European supervisory authority? It is interesting to note that this question is not always clearly addressed. The comitology process initially proposed by the Lamfalussy Group for securities markets supervision and now extended to banking and insurance supervision is being designed to speed up decision processes. There is no lack of such committees to discuss and co-ordinate at a European level, but could there be a need for a supranational supervisor?

The proponents of a Pan-European solution – in the securities sector Averginos (2003) has recently published his arguments pointing in the direction of a single European Securities Supervisor – argue that such a framework would best fit the needs of financial institutions doing business in the Common Market. They point out that a Pan-European or global view of financial markets would make supervision of multinationals more effective. It is not clear, however, how to separate responsibilities from, and how to design, the necessary interfaces with national supervisors. The European view on banking and insurance clearly cannot go beyond the systemic stability part of the exercise. The current development within the EU is towards a system of national supervisors following those financial institutions they have to supervise due to the home-country principle wherever they have business. This may bring along difficulties if some big players compete in the same market and may be supervised be two different authorities. Besides having contact to the multinational players it might be difficult for a single EU supervisor to be close to the market and provide quick decisions.

A two-tier system of supervisory responsibilities may be best-suited from that systemic stability point of view. As far as consumer protection is concerned, however, a division of competences between national and supranational supervisory entities might be suboptimal.

Figure 4: **The Lamfalussy / Comitology Architecture**



The shape of the future European system of financial sector supervision is just about to emerge. It is of course a tricky task for the system's designers to bring the conflicting requirements under the same roof. In our view there is a chance to establish a new kind of regulatory competition that keeps the original European idea of institutional competition alive. A decentralised structure for prudential supervision with coordination between the national supervisors, towards which we are currently striving, will nevertheless need strong secretariats at level-3-committees. It will be their task to carry out the necessary horizontal studies on all topic questions and establish clear patterns of coordination for all possible cases. In recent decades this competition has allowed innovation and best practices to flourish; such an approach may be the ideal way to ensure that Europe's supervisory institutions – and therefore its capital markets and institutions – remain competitive at a global level.

Notwithstanding our general caution of mixing up responsibilities and moving away from clear-cut and separable responsibilities augmented by a strongly developed culture of accountability, we want to underline the necessity of all involved parties – Central Banks and Financial Sector Supervisors, to cooperate closely and exchange information on a regular basis. A clear institutional setup and relevant information directed to the place where it is needed will grant an optimal achievement of each individual goal best.

Summary and Conclusion

We want to contribute to the ongoing discussion about the institutional settings of financial market regulation/supervision in a twofold manner:

Firstly, we should like to point out that there are **potential conflicts of interest** due to clearly defined targets of public institutions in the financial markets, such as central banks, regulators and supervisors, but also competition authorities and consumer protectors, which should not be mixed. Also some **behavioural aspects** should be taken up in the discussion again. Every regulated industry has incentives to capture regulators in order to reach their economic goals through undermining the regulatory goals of other regulators. This may e.g. be the case with competition authorities, which would like to see low market entry barriers. Their goal may be obstructed by prudential supervisors, who do not like to see the market entry of companies which are not 'fit and proper'. Therefore, every institution may be tempted to pursue its own institutional targets at the possible expense of others. An additional aspect is the existence of individual target functions of decision makers within these institutions. However, a separation of tasks and institutions makes target conflicts explicit and much more transparent and minimises political interference.

The importance of supervisory independence is often underestimated, and furthermore has to be safeguarded against all possible attempts of capture. It is thus a public good comparable to the – by now – well established monetary independence of central banks.[6]

Second, we try to address the **European view**: The future design of financial supervision in Europe will have to take into account that the tasks of supervisors and regulators are highly connected with the enterprise-customer-relationship and are therefore probably best fulfilled decentralised, while of course the ongoing integration of markets strongly underpins the necessity for harmonisation and coordination. However, this decentralised structure for prudential supervision, towards which we are currently striving, will need strong secretariats at the third level of the comitology architecture in the EU.

Unlike others, we remain specifically sceptical vis-à-vis arguments for a European micro-prudential banking and insurance supervisor on the grounds of one-stop-shopping for Pan-European enterprises or the closing of loopholes since we do not see the problem stop at any European border. It would take a World Financial Authority, as proposed by Eatwell[7], to accomplish this – a goal way too ambitious to be realistic. When creating any kind of supranational authority we should also keep in mind that we may well reduce (horizontal) transaction costs in the supervision of multinationals, but at the same time create (vertical) transaction costs due to the necessary coordination between supranational and national levels. Furthermore, a two-tier system of supervisory responsibilities may be best-suited from a systemic stability point of view. As far as the supervision of market conduct is concerned, which is complementary to prudential supervision, a division of competences between national and supranational supervisory entities might be suboptimal.

6 See Quintyn/Taylor (2002), p 34.
7 See Davies (2003).

Supervision and regulation are organised decentrally in Europe with a strong focus on cooperation and coordination. We see this tradition of 'competing' authorities as a strong asset of the European approach which should not be discarded without necessity.

Literature:

Avgerinos, Yannis V.: *Regulating and Supervising Investment Services in the European Union*. Houndmills 2003.

Barth, James R.; Nolle, Daniel E.; Phumiwasana, Triphon; Yago, Glenn: *A Cross-Country Analysis of the Bank Supervisory Framework and Bank Performance*. Financial Markets, Institutions and Instruments, V 12, No.2. Oxford 2003.

Barth, James R.; Caprio, Gerard Jr.; Levine, Ross: *Financial Regulation and Performance: Cross-Country Evidence*. World Bank Working Papers. November 1998.

Crockett, Andrew: *Central banking, financial stability and Basel II*. Speech at the 38th SEACEN Governors' Conference, Manila, 13 February 2003.

Davies, Howard: Is the global regulatory system fit for purpose in the 21st century? BIS Review 25/2003. Basel 2003.

Goodhart, Charles: *The organisational structure of banking supervision*. In: Financial Stability and Central Banks – a global perspective. Healey, Juliette et al. (Eds.), Central Bank Publications. London 2001.

Issing, Othmar: *Monetary and Financial Stability: Is there a Trade-Off?* In: BIS Review 16/2003. Basel 2003.

Kahn, C.M.; Santos, J.A.C.: *Allocating Bank Regulatory Powers: Lender of Last Resort, Deposit Insurance and Supervision*. Monetary and Economic Department, BIS Working Papers 102. Basel 2001.

La Porta, Rafael; Lopez de Silanes, Florencio; Shleifer, Andrei: *Law and Finance*. In: Journal of Political Economy, vol. 106, no. 6, pp 1113-1155, 1998.

Lanoo, Karel: *Supervising the European Financial System*. CEPS Policy Brief No.21; Brussels 2002.

Mishkin, F. (1991): *Anatomy of financial crisis*. NBER Working Paper, No. 3934.

Quintyn, Marc; Taylor, Michael W.: *Regulatory and Supervisory Independence and Financial Stability*. IMF Working Paper, March 2002.

Posner, Richard A.: *Theories of Economic Regulation*. In: The Bell Jounal of Economics and Management Science, Vol.5 Issue 2, pp. 335-358, Autumn 1974.

Stigler, George J.: *The theory of economic regulation*. In: The Bell Jounal of Economics and Management Science, Vol.2 No 1, pp. 3-21, Spring 1971.