FINANCIAL STABILITY AND OPTIMAL SUPERVISION IN THE EU 15

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Financial Stability, regulation and supervision are intertwined. Supervision exists because there is regulation and regulation exists because its main objective is to preserve financial stability to avoid a long historical and costly experience of national, regional and systemic crises of financial institutions.

Financial Stability and supervision in the world in general and in the European Union in particular is becoming increasingly complex and difficult to achieve for several reasons:

First, financial institutions are becoming increasingly international, having affiliates in many different countries under different regulators and supervisors. Second, financial institutions are increasingly becoming financial conglomerates and covering all financial services: commercial and investment banking, insurance and pensions, securities trading, asset management and merchant banking, so they have to be supervised by different institutions in each country. Third, the consolidation of financial institutions is progressively increasing both within borders and across borders. Fourth, financial products have become increasingly complex and sophisticated, because they are based on mathematical models of great complexity, and need very skilful regulators and supervisors to properly understand them and to guess their level of risk. Fifth, short term "return on equity" and "shareholder value" have increasingly become the main objectives for managers of financial institutions, thus, giving them an incentive to take up more risk. These five trends make financial institutions stronger, more diversified and resilient, but, at the same time, their pro-cyclicality and correlation are becoming larger, increasing the probability of systemic crises.

In this rapidly changing environment, the present structure and systems of supervision in the EU have an increasing difficulty to cope with these new challenges, even more in the case of an unexpected systemic crisis. At the moment, in most member states of the EU 15, regulation is done generally by governments and sometimes by the EU institutions and supervision is done by a different array of structures. Banking supervision has been done traditionally by the national central banks, but today, in more than half of its member states the central bank is involved in the supervision, but in some cases not directly, not exclusively, or not at all: Austria, Belgium, Denmark, Germany, Finland, Ireland, Luxembourg, Sweden and the UK are in one of these three categories. Moreover, securities and insurance supervision are mostly done by other agencies, which run from 1 agency in the case of Belgium, Finland, Luxembourg and the Netherlands; to 2 agencies, in the case of Greece, Italy, Portugal and Spain and to 3 agencies, plus the Ministry of Finance, in the case of France. Finally, there are a six member states where all supervision is centralized in one institution, as is the case of Austria, Denmark, Germany, Ireland and Sweden and the UK.

In all, there are around 40 financial supervisory authorities in EU 15 member states. As a consequence, EU supervision is mainly based on the principles of subsidiarity, minimum harmonization, home country control and mutual recognition. The obligation to cooperate and coordinate based on these principles is legally binding to EU member states. Internal cooperation between these national supervisory authorities is based on a network of bilateral memoranda of understanding (MOU). The latter are supplemented by a growing number of multilateral committees, either by sector (the Committee of European Banking Supervisors (CEBS) and the Banking Supervision Committee of the European System of Central Banks (ESCB) for banks, the Committee of European Securities Regulators (CESR) for securities, and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) for insurers, or across sectors, among these three committees.

The first rational reaction to this too complex and diverse supervisory structure should be of worry. How are these large and diverse numbers of supervisors, going to act together and in a quick and urgent manner in the case of a liquidity crisis, similar to the one in 1998, in order to avoid a systemic risk?

Nevertheless, two European reports published in the last few years do not show much worry and are confident that cooperation is still the main solution to the present structure:

First, the two reports commissioned by the ECOFIN Council on the issues of financial stability and crisis management (Brouwer I and II) concluded that the financial supervisory structure in Europe needed only minor adjustments and called for more cooperation between supervisory authorities, especially on cross-sector basis, for a better exchange of information, for harmonization of supervisory practices and for the participation of central banks.

Second, more recently, the Inter-Institutional Monitoring Group (IIMG) which members are six independent experts of different institutions, mandated by the European Parliament, the Council and the European Commission has published its first interim report about "the Lamfalussy Process implementation progress and any possible emerging bottlenecks". The report calls for greater efforts in making further progress in its implementation, within CEBS, allowing supervisors to stepping up progress in this field and governments to give them necessary political support.

Nevertheless, there are increasing demands to improve and change the present supervisory structure of the EU:

First, large banks and even individual supervisors, as FSA's Callum McCarthy, are calling for moving European supervisory structures into the direction of "lead supervisor", by which the home-country supervisor responsible for the parent of a financial group would take on the function of a lead supervisor responsible for all of the group's subsidiaries and branches as well as in all sub-sectors of on going supervision, throughout Europe.

Second, the European Commission White Paper on Financial Services Policy 2005-2010 expressed the need for clarify and optimize home-host responsibilities to be able to deal with potential spillover effects for the European Union; the need to explore delegation of tasks and full responsibilities for the supervision of a subsidiary to the parent company's supervisor; the need for a truly common data, reporting requirements and supervisory databases and the need to deliver a pan-European supervisory culture. Moreover, the Green Paper which was the basis for the White Paper stated that "more consolidated supervision is a legitimate demand by industry; however it should be a long term objective".

Third, even more recently, Edgar Meister, the Chairman of the Banking Supervision Committee of the European System of Central Banks (ESCB), in a speech at a group of debate at the European Parliament mentions with great worry: "On 27 march 2007, ECON will probably adopt a report on the Commission White Paper on Financial Services Policy 2005-2010, which advocates, in surprisingly clear language, a centralized supervisor for Europe. In paragraph 34, ECON notes that for a real oversight of the systemic and prudential risks of the top players in the market, the present system of cooperation is too weak. Therefore, it promotes a well-equipped executive European prudential supervisory authority inside that system and endowed with the appropriate competences for supervision of large cross-border and cross-sector financial conglomerates".

It is absolutely clear that the present financial supervisory structure of the EU shows a number of issues that need to be tackled in order to avoid major problems and risks in the future and that they can be addressed in a sequential way:

First, issues related to the large number of rules applied by different supervisors, which become excessively cumbersome for the financial institutions that are trying to consolidate the financial European system, through the necessary cross-border integration. Thus, rules should be based on shared principles and not on specific regulations, these principles should be the same for all member states and for all their individual supervisors, they should not place too much burden on financial institutions and they should be consistent with markets conditions.

Second, issues related to the large number of different national supervisory structures, which may impose, at the beginning, to achieve an agreement by all member states supervisors on the idea of having “lead supervisor” for financial institutions which have subsidiaries and branches in different member states. Later on, a progressive reduction of the large number of national supervisors and also a convergence towards a single supervisory model should be achieved in each member state. The most obvious way is to try to progressively concentrate all financial supervision in the supervisor of each member state which has clearly shown to be the most efficient.

Third, issues related to the “burden sharing” among affected member states in the event of cross-border financial crises. There is a clear need for reaching agreements among member states’ fiscal authorities as to the way and conditions they will share the costs of the crisis and how they will cooperate with their financial supervisors to face such a crisis in order to minimize that burden.

Fourth, issues related to the convenience or even necessity to have a pan-European supervisor as there is already a single European Central Bank and eventually and hopefully a single European financial system.

There is not yet a theoretical or political consensus about these four issues in the EU, except for the first:

The idea of the “lead supervisor” has the advantage that each one of the member states’ supervisors knows in advance that it has the full responsibility to act quickly and efficiently when there is crisis in a bank which parent company is a resident in its own member state. Its main disadvantage is that the hosts of cross-border financial groups from other member states will not have much of a say and may think that they are losing sovereignty, but, on the other hand, it is clear that they benefit for not having to deal with the crisis themselves. There is also the issue of supervising differently large cross-border banks from national in-border banks.

The idea of converging into similar national supervision models and, more specifically, into a single supervisory agency, as those of Austria, Belgium, Denmark, Germany, Finland, Ireland, Luxembourg, Sweden and UK, is also still quite controversial.

On the one side, the view of the ECB and of many members of the ESCB is that the national central banks have a natural advantage to be supervisors because of their knowledge of the overall economy and the financial system, and their information from payment and settlement systems and monetary policy operations are very valuable for any supervisory task. Moreover, conversely, if these national central banks have supervisory duties and information, these can play an important role in the oversight of payment and settlement systems and of market infrastructures, as well as helping to manage liquidity crisis.

This view is also supported by economic theory that shows that central banks have informational economies of scope between monetary policy, lender of last resort (LOLR) facility and supervision. It is also supported by the facts since this is what happens in many EU member states in which the central bank either does also supervision or in the case it is done by other agency, the central bank is also involved in the supervision, given its informational advantages. Further evidence comes from the New York FED which plays a key role in supervision, helping the other supervisors and playing a major role in the management of financial crises.

On the other side, there is another point of view showing that central banks can incur into conflicts of interest if they manage, at the same time, monetary policy and financial supervision. They may be looser in their monetary policy stance if they see that some domestic banks may be close to a liquidity or solvency crisis, given that a crisis will affect to its reputation as a supervisor and even affect the credibility of its monetary policy. There is empirical evidence showing higher inflation in countries in which the central bank is also the supervisor. In that case, the single supervisor should be a non central bank institution.

In any case, there are two strong cases for an integrated national supervisor: one is that financial institutions are increasingly becoming financial conglomerates which engage in banking, insurance and capital markets acting on a multinational or even global scale. A sector by sector supervision may rend difficult a correct valuation of all the risks incurred by these conglomerates. Another one is that fragmented and complex national supervision is becoming an obstacle to the necessary financial consolidation and integration of the EU financial markets. The empirical evidence available shows that it affects not only to banking, but also to insurance and stock markets.

The idea of achieving eventually a single supervisor for the whole EU shows the same or even a greater disagreement because of the same arguments of above plus the fact that will cover the whole financial system of the EU and it will entail far reaching political implications. On the one side, it may need (although it is disputed by different constitutional experts) an amendment of the EU Treaties, followed by the necessary ratifying process by every member state, which is losing sovereignty; second may need creating a single supervisory procedural law for all member states; third, may need a uniform insolvency legislation for all member states.

There are three dominant views among academics and policy makers about the structure of a potential European Single Supervisor:

The first one is that the ESCB and the ECB should be the main and sole guarantors of the stability of the EU financial system. Ad hoc cooperation and coordination in crisis situations will not be sufficient and may endanger the stability of the system. The necessity of a quick intervention in a crisis enhances the value of a centralized authority. The ESCB should assume the function of guarantor of the system but the ECB will need to play a key role in determining the policy as regards the ways in which to intervene and take the initiative, while the one or several members of the ESCB will apply it. Given the lack of a central fiscal European authority, the ECB should sign a MOU with the national central banks and other supervisors to clarify responsibilities, achieve access to supervisory records, establish information sharing protocols and elucidate who would pay for the failed institutions that have been helped.

The second one is a European Financial Services Authority (EFSA) as it is the case in the UK. The main arguments for this second alternative are, on the one side, to avoid conflicts that may arise between the monetary policy and the supervision policy of the financial system, which may affect the credibility and reputation of the ECB and, on the other side, to cover not only banks but also insurance companies and capital markets, reducing the fragmented supervision which is an obstacle to European financial integration and helping to a better assessment of the total risks of financial conglomerates.

The third one is a combination of the previous two, the EFSA and the ECB. This option will allow for exploiting the economies of scope of the ECB as the lender of last resort and its knowledge and experience on the payment systems and its knowledge of the liquidity situation of financial institutions. It will also avoid the ECB's conflict of interest between monetary policy and supervision; it would resist better the local pressures to assist particular institutions; it would facilitate and improve accountability and it will not increase the power of the ECB that it is view sometimes as too powerful and too little accountable. The main problem with this alternative is that it will take even more time to be implemented than the other two.

Within this third alternative there are two ways to allocate the supervision between the ECB and the EFSA, following the recent experience by the UK and the Netherlands in their new supervising structures. In the case of the UK, the Bank of England is in charge of the macro prudential stability of financial institutions while the FSA is in charge of the micro prudential stability of financial institutions and of the capital markets supervision. In the case of the Netherlands, the Nederlandsche Bank is in charge of both macro and micro prudential stability of financial institutions and the Financial Markets Authority is in charge of the supervision of capital markets. Any of the two could fit into the potential European Supervisory System

Finally, the issue of "moral hazard" in the management of crises can be avoided it the lender of last resort follows strictly the rules established by Bagehot in 1873: "Only solvent banks with liquidity problems should be assisted and this should be done with loans at a penalty rate and against good collateral, evaluated in normal times".