

## THE STRUCTURE OF FINANCIAL SERVICES SUPERVISION

**Summary:** Any discussion on the future structure of financial services supervision in the EU must take as its guideline the objectives of financial market supervision. These include systemic stability, efficiency and competitive neutrality. Moreover, the structure of financial services supervision should support the aim of creating a single market for financial services in the EU. Deficiencies of the previous structure were generally acknowledged, and there is wide agreement on the need for an intensification of co-operation between national supervisors. Consequently, new pan-European arrangements for supervisory collaboration are now coming into effect, whose adequacy for the purpose is as yet largely untested. Although there is growing agreement on extending Lamfalussy-type structures to banking and insurance markets as well as financial conglomerates, there are widely divergent views as regards, on the one hand, the role of central banks in financial services supervision and, on the other hand, the need for a supranational European supervisory authority.

### **The background**

The supervisory regime in the EU was, by and large, unaffected by EMU. No changes were made to the institutional structure of financial services supervision. However, it is important to realise that EMU is not the only reason for the discussion on the future shape of supervision in Europe: the discussion must be seen against the broader background of increasing integration of financial markets across borders and sectors; the political commitment to create a single European market for financial services; the creation of integrated financial supervisors in some member states (notably in the UK and in Germany); EU enlargement; and the EU Convention.

### **The aims and status quo of financial services supervision**

The discussion on the future structure of financial services supervision in the EU must take as its guideline the objectives of financial market supervision which include: efficiency, transparency of both rule-making and rule-application, responsiveness to financial market innovation, investor and consumer protection, competitive neutrality and systemic stability.

Presently, the landscape of financial services supervision is based on the principles of minimum harmonisation, home country control and mutual recognition. The obligation to co-operate and co-ordinate based on the aforementioned principles, is legally binding to EU member states. There are 40-odd supervisory authorities in EU member states. International co-operation between those institutions is based on a network of bilateral memoranda of understanding (MoUs).

The bilateral MoUs are supplemented by a growing number of multilateral fora (*see annex*). It is necessary to distinguish between those that are of a regulatory nature, and those that are of a supervisory nature. A cross-sectoral dimension has been largely absent from the committee structure until now. Both the regulatory and the sectoral supervisory committees have acquired greater prominence recently in the context of the proposals by the Group of Wise Men ("Lamfalussy Group"). The ESC and CESR are already active as level 2 and level 3 committees.

The official view emanating from the two reports commissioned by the Ecofin Council on the issues of financial stability and on crisis management in the EU ("Brouwer I" and "Brouwer II") was that the financial structure in Europe needed only minor adjustments. These reports called for more co-operation between supervisory authorities, especially on a cross-sectoral basis; for a better exchange of information on systemically important institutions; for a harmonisation of supervisory practices and the participation of central banks.

### **Criticisms of the current structure**

The Brouwer reports concluded that the current structure has a number of strengths but that the system could be supplemented by greater co-operation between authorities.

The current structure can be differentiated according to its objectives into those that relate to the objective of financial stability and those that relate to other objectives of financial services supervision.

- *Efficiency:* Multiple reporting requirements imply a cost burden to institutions operating in more than one member state. Currently, the *Forum Group on Reporting Requirements* convened by the European Commission is compiling evidence on the burden to industry stemming from these multiple reporting requirements. Multiple reporting also causes a competitive distortion as large institutions can carry the additional cost burden more easily than small ones.
- *Inconsistent implementation:* As noted in the Lamfalussy report, inconsistent implementation of EU legislation is a widespread phenomenon and is a major obstacle to a single market. This is due to several factors: the scope for national discretion which EU legislation allows, in particular the "general good" provision found in most legislation; and the fact that different supervisors enjoy different levels of competence and attach different relative weights to the objectives. .
- *Europe's voice:* It could be argued that the fragmentation of financial services' supervision also undermines the EU's effectiveness in international negotiations on financial market regulation. On the other hand, EU states have 9 seats at the Basle Committee, giving them an important voice.
- *Effectiveness:* There is reason to presume that the current arrangement may not be conducive to guaranteeing an effective supervision of institutions operating in several Member States. These concerns have been voiced by the IMF and the BIS. For instance it could be argued that national supervisors' responsibilities to maintain financial stability is limited to their respective jurisdiction, although there are a number of EU and international forums that specifically address financial stability more widely. This may be sub-optimal from the European point of view.

For example, procedures for crisis management are not transparent. The ECB and finance ministers have repeatedly stated that "procedures for crisis management are in place" without revealing any further details. It is true that broad responsibilities follow logically from the institutional arrangements, such as home country control. It is also true that "constructive ambiguity" is an accepted concept as regards the lender of last resort function of central banks. But, uncertainty must be avoided in a crisis. It is, therefore, necessary that there be clear lines of communication for co-ordination in a crisis situation. An example of

the effectiveness of such co-operation was in the rapid response of supervisors to the events of September 11<sup>th</sup>.

### **Discussions on the structure for financial services supervision for Europe**

There are several proposals under discussion at the moment. Essentially, they differ on two issues: to what extent should central banks be involved in financial services supervision, or more specifically, in banking supervision? Secondly, should there be a single European financial services supervisor or merely an intensification of bilateral and multilateral co-ordination?

The extent of the involvement of the central banks is a perennial question in the context of designing the structure of financial services supervision. Essentially, it entails balancing, on the one hand, the benefit from using the information on financial market stability, which a central bank obtains through its operations, and, on the other hand, avoiding conflicts with other central bank objectives and structures. In particular, there is concern that the objectives of a financial services supervisor may conflict with those of a central bank. Moreover, it is feared that the central bank's reputation might be tainted if supervision failed. Finally, there is a conflict between the autonomous, independent status central banks need to have and the necessary political accountability of a supervisor.

One can argue that the most efficient institutional structure is to place financial services supervision at an independent, but politically accountable agency, which, at the same time, is mandated to maintain a close exchange of information with the central bank. This is the structure successfully employed in a number of countries, including the UK and Germany.

### **The ESCB's proposal**

The ECB and many national central banks have called for banking supervision in Europe to be entrusted to central banks. In this model, the leading role for co-ordination on a European level would be given to the existing Banking Supervision Committee (BSC) of the ECB, headed by a central banker (currently the Bundesbank's Edgar Meister). In order to respond to the aforementioned concerns, the BSC would be made independent of the ECB and report to Ecofin. While these provisions would alleviate concerns somewhat, they would not remove the inherent conflict between both functions. More importantly, the ECB's model would preclude a cross-sectoral structure of financial services supervision and would do little to reach the other goals of supervision. There is also an issue regarding the extent of ECB involvement in the supervision of EU banks authorised outside the eurozone.

### **The Brown-Eichel initiative**

The second major proposal on the table is the Brown-Eichel initiative. Basically, this implies extending the "Lamfalussy-type structure" recently established for EU securities market regulation to banking, insurance and financial conglomerates. Mirroring the ESC and CESR there would be two committees each for these three areas. Responding to central banks' demands, the ECB and the chairman of the BSC would have observer status in the European Banking Committee and national central banks involved in banking supervision would naturally be represented on the banking supervisors' committee. Open questions include: who (Commission or Member States) will chair the European Banking Committee and will the EP,

which has expressed concerns about democratic scrutiny of the Lamfalussy-type structure, agree?

Extending the Lamfalussy structure to banking and insurance markets has generally been welcomed. It promises to make financial market legislation and regulation more flexible. However, there are questions whether the structure envisaged will make financial services supervision more efficient and effective. True, closer co-operation in the regulators'/supervisors' committees will help to facilitate an exchange of information and may help to align supervisory practice by staff exchange, joint communication and interpretation, peer reviews, comparison of supervisory practices and administrative guidelines. However, the realisation of the Brown-Eichel proposals will entail a web of at least eight (probably more) committees and it will retain a largely sectoral approach to supervision, although two of the committees, responsible for financial conglomerates, will be cross-sectoral. Thus, there is a danger that committees will focus their attention on their respective market segment rather than taking into account the overall distribution of risk in the financial sector. Finally, Eichel-Brown will only to a limited extent (via work on common interpretations and rules) address the concern of those institutions which believe they may suffer a competitive disadvantage due to the practices of certain national supervisors.

### **The EFSA proposal**

There are two broad lines of argument in response to these issues.

A number of people and institutions, including some from the financial industry, have argued for the creation of a supranational European Financial Supervisory Authority (EFSA) as the logical and institutionally sound solution, which could strengthen EMU, the single market and the EU's voice in international negotiations. They argue that the need for a harmonized legal foundation would not be insurmountable if there is political will, and that such a development is not inconsistent with subsidiarity principles which underpin the EU. For them an EFSA might have the following features:

1. Decentralised structure akin to ESCB, i.e. a European System of Financial Supervisors (ESFS). The ESFS would have EFSA at the centre. EFSA would harmonise (as necessary) and co-ordinate (as appropriate), develop common principles and guidelines, and make sure that rules are interpreted and implemented in a consistent way across all member states. In particular, the central EFSA would be the highest authority within the ESFS able to give instructions to national supervisory agencies.
2. The national agencies in turn would be responsible for implementing the rules agreed upon at European level. Being close to the supervised institutions, they could duly take into account national characteristics. However, it may be sensible to have those banking groups that operate on a truly European scale supervised directly by the central agency. Ideally, the structure of national authorities would mirror those of the EFSA (see below 3-5).
3. It would be cross-sectoral (like UK's FSA or Germany's BAFin)
4. It would be autonomous from the EU institutions; but report to the EU Commission and have ex post accountability vis-à-vis the Council and the EP.
5. It would be separate from the ECB and from national central banks.

Creation of EFSA would require a change to the Treaty on European Union. Some say that the window of opportunity provided by the EU Convention could be used to lay the necessary constitutional and legal foundations. For this an enabling clause inserted into the revised Treaty / Constitution could state that the EU, upon a qualified majority vote among Member States, may create the EFSA.

A different view is taken by some others, both supervisors and financial institutions, who argue that determining in advance the need for an EFSA is a top-down approach, which risks creating a remote and inflexible European institution which would add little if anything in terms of investor protection or systemic stability. According to this point of view:

- Lack of effective coordination among supervisors was the reason for establishing CESR in the securities field and the capacity of this mechanism to address the problem has not yet been tested
- Debating the need for an EFSA now is a distraction from the important task of making the new pan-European structures work
- It would be more effective and beneficial at this stage to focus on completing and implementing the Financial Services Action Plan, and to identify concrete measures to increase convergence in legal and supervisory practices, without the distraction of creating a single pan-EU regulator.
- That putting enabling clauses in the Treaty would pre-judge the ultimate destination with regard to an organization the need for which is unproven.

There are many variations on these arguments. For example, some favouring an EFSA argue that Lamfalussy-type structures should first be set up across all FS sectors, as a transitional stage. Others, not currently convinced of the merits of an EFSA, argue that institutional decisions should at least keep open the option to move in this direction in the future if the need is proven and there is consensus.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

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**Annex:** Survey of existing multilateral fora:

**I Sectoral regulatory committees**

1) *Banking Advisory Committee (BAC)*

- High-level representatives of the finance ministries, the banking supervisory authorities and the central banks and from EU Commission (COM)
- advises the Commission on issues of European legislation, to the extent that it involves supervisory matters
  - meets three times a year;

2) *European Securities Committee (ESC)*

- High-level representatives from finance ministries and COM
- Advises the Commission on issues relating to securities legislation; will also act as regulatory committee assisting the COM in exercising implementing powers.
  - Meets regularly

3) *Insurance Committee (IC)*

- High-level representatives of the finance ministries, the insurance supervisory authorities and COM
- Serves as advisory forum to COM; assists COM in exercising comitology powers.
- Meets at least three times a year.

**II Sectoral supervisory committees**

1) *Banking Supervision Committee (BSC), an ESCB committee*

- High-level representatives from central banks, banking supervisors and ECB
- assists the ESCB as consultant when it considers measures to stabilise the financial system, multilateral forum for information exchanges
  - meets for or five times a year

2) *Groupe de Contact (GdC)*

- informal forum of middle management banking supervisors
- exchange of information on general regulatory issues and on individual institutions
- meets at least three times a year;

3) *Committee of European Securities Regulators (CESR, formerly, FESCO)*

- High level representatives of securities supervisors
- advises COM on technical implementing measures; shall ensure alignment of supervisory practices
- meets on a regular basis

4) *Conference of Insurance Supervisory Authorities (CIS)*

- High-level representatives from insurance supervisors
- Supervisory co-operation and exchange of information
- Meets twice a year

**III Cross-sector Committees**

1) *Cross-sector Roundtable of Regulators (CRR)*

- Chairpersons and secretariats of BAC, BSC, GdC, ESC, CESR, IC and CIS
- Informal exchange on cross-sectoral views
- Meets on a regular basis

2) *Mixed Technical Group (MTG)*

- Experts from regulatory and supervisory authorities for banking, securities and insurance plus COM
- Cross-sectoral forum working on prudential issues
- Meets four times a year.