Supervision of pan-European financial institutions

Summary

- *The current system of national supervision leads to supervisory overlap and complexity for cross-border firms acting in the banking sector as well as for multi-jurisdictional operators of markets such as stock exchanges. Although most of the difficulties encountered by those two groups are similar, solutions may differ.*
- *For financial institutions, if a crisis arose at a subsidiary located in a different member state to the parent company, it is not always clear which supervisor would be responsible for dealing with the situation.*
- *An efficient and effective supervisory framework requires all elements of the safety network for banks to fit into an overall architecture in which all stakeholders understand their responsibilities and are able to act together.*
- *Further analysis of the situation is needed; any action should respond to market evolution and institutional changes should only be considered if evolutionary action is judged inadequate.*
- *For multi-jurisdictional operators of markets, the issue is to determine how several "home" regulators with equivalent concerns and duties over a multi-jurisdictional entity can exercise their powers in a manner that allows for smooth and cost efficient operation in several jurisdictions.*

The current situation: how does "national" supervision work?

The integration of financial markets leads to integrated financial institutions, cross-border business and cross-border groups and greater likelihood of cross-border spillovers of financial distress. This evolution takes place on a global basis and affects not only the financial sector but also non-financial companies such as infrastructure providers for financial operations and stock exchanges. For the purposes of this paper, our scope will predominantly deal with the prudential supervision of banking institutions in the European Union. It does not cover the supervision of non-bank financial institutions such as investment firms which do not take deposits and do not have the support of the Central Bank as lender of last resort, but nevertheless represent a significant segment of the financial market.

The goal of a regulatory framework must be to achieve an appropriate level of regulation that is both effective and efficient. The regulatory framework in the EU has evolved over time into a complicated puzzle of different supervisors looking at different aspects of risks in the financial sector and is marked by overlaps between different supervisory authorities. Micro prudential supervisors, market conduct supervisors, deposit guarantee schemes, the lender of last resort, financial stability overseers and also treasuries all watch over and, where necessary, intervene in the financial sector.

The micro prudential supervisor has to develop a framework in which banks maintain the capability to pay back deposits, even in economic downturns. The solvency of a bank is key and is the driving concern behind capital requirements and internal organisation. The organisation of prudential supervision differs between countries, sometimes as a specialised stand-alone institution, sometimes integrated into the central bank.

The lender of last resort helps solvent banks in case of liquidity problems. This role is fulfilled by the central bank, issuer of basis currency. The supervision of *financial stability* is also a responsibility of the central bank.

The deposit guarantee scheme protects deposit holders in case a bank should fail. However, such schemes exist essentially to protect a limited amount of capital and only function in case of a small crisis. In case of a major bankruptcy or banking crisis, a scheme's funding may be insufficient. In such a case, governments may, directly or indirectly, intervene and, on rare occasions the burden will fall on the tax payer.

While in theory, each of these supervisors has a well identified role, in reality supervision becomes far more complicated when real problems arise. At this point, all types of risks and supervision become interrelated: liquidity problems can become solvency problems if they are not tackled in an efficient and timely way.

Successful handling of crises requires all supervisors to act together in a creative way in order to restore confidence. Conflicts of interest between supervisors do exist but there must be a mechanism available that guarantees that these problems do not lead to delay in taking action. For a financial sector in crisis, hesitation is the worst situation imaginable.

As long as the prudential supervisory framework is organised at national basis for local banks, there is always a supreme authority, be it government or even parliament, that can operate as an arbiter and a national budget is available in case of crisis management. This model however becomes more complicated in the case of a cross-border crisis. Interests of different countries can differ and decisions of a supervisor in one country can have a negative impact on the situation in another.

This is the problem of so-called “externalities”. It explains why supervisors may be reluctant rely completely on their colleagues from other countries for problems concerning their own country. As long as supervisors are primarily accountable to their national parliaments, they will to an extent have a “nationalistic” reflex, even if they are aware that in an integrated market, this will not lead to more effective crisis prevention or crisis handling. This is a dilemma that EU prudential supervision is facing today, and which the various Committees of European Supervisors are conscious of.

Current EU supervisory framework for cross-border groups

For cross-border groups, prudential supervision is essentially organised at the level of the legal entity. A cross-border group has, as a consequence, as many supervisors as the number of countries in which subsidiaries are active (plus the home country supervisor, which is also responsible for the supervision of a group on a consolidated basis). For branches, on the contrary, only the home country is responsible. Certain aspects of *micro-prudential supervision* are, even for groups of subsidiaries, executed by the consolidating or home supervisors.

For *liquidity assistance*, banks have always to address the central bank of the country in which the operation is established, also if it is through a branch. This is a pragmatic rule if different currencies are involved, but it is not parallel to the prudential supervisory set-up.

Deposit guarantee schemes essentially follow the same structure as prudential supervision, but for branches a combination is possible, through which deposit holders are protected by the scheme of the country of the parent company and the scheme of the country of the branch.

This complex puzzle is leading to complicated home/host relations between supervisors. Furthermore, the powers, responsibility and tools of these supervisory frameworks can differ from member state to member state, which makes common approaches difficult.

While this situation has existed for years, in the past it has not led to significant problems. That was essentially because financial integration in the EU was more theory than practice. The operations in the different member states were fully fledged banks, often even operating under different brand names, with all back office and front office functions developed in each of the operations. These subsidiaries almost functioned at arms length from their parent companies, who acted as holding companies. In case of problems it was relatively easy to carve out the subsidiary from the parent company structure and to find a national solution for it.

In the new cross-border banking model, however, key functions and integrated platforms for operations are becoming centralised in different EU countries whilst distribution functions remain local in subsidiaries and branches. This economically sound evolution has important consequences for the functioning of the group and its subsidiaries. Understanding what happens within one subsidiary on a stand-alone basis is becoming impossible as major decisions are taken outside the country. Only at the consolidated level it is possible to judge overall quality and risk of the group.

Supervisors taking decisions only on the operation in their country without understanding the whole picture might even increase the global risk of the group. In the case of a crisis, supervisors trying to limit the “national” damage might create even bigger, global, problems with an end-result that will have a knock-on effect on them.

This evolution explains why supervisory reform in the EU has an increased priority today. The gap between supervisory practice and market practice has grown and leads to inefficiency and ineffectiveness: ineffectiveness because the only way to understand market reality is to look at a global group at the consolidated level and inefficiency because a multitude of separate supervisors, each taking separate decisions, is expensive, hurts financial integration, will not avoid crises and could even create chaos in a crisis.

The way forward

There is consensus on the need for convergence and coherence of EU prudential supervision and a growing consensus around the need for cooperation between supervisors. The goal is to arrive at a situation where all involved supervisors act coherently and consistently.

One possible solution for cross-border institutions may be a model where one supervisor is appointed from among the local supervisors of a group to lead for all aspects of prudential supervision of that group on an EU-wide basis and coordinate actions with all the supervisors involved.

Capital requirement rules are an important element of prudential supervision but there is more to it than solvency alone, such as deciding about on-site inspections, approving cross-border set-up of functions and liquidity rules at group and local level.

Any “lead supervisor” would not act in an isolated way, but would rely on the support and expertise of all local supervisors involved. Together, they should form a college, specific for each financial group. The college would be a platform for exchange of information and discussing the global picture. It would also be the ideal place to discuss supervisory initiatives and which tasks fall to whom. If for any issues it is impossible for the college to reach agreement on the decisions of the lead supervisor, a mediation mechanism should be available, through which disputes can be settled. Although care should be taken to avoid imposed decisions, checks and balances should not lead to situations where no decisions at all are taken.

Important elements of this model are already present or at least prepared in the existing framework:
- Supervisors have a long tradition of MOUs and cooperation in supervising cross-border groups;
- The need for consolidated supervision is one of the major messages of the Basel II debate about banking solvency requirements;
- The CRD explicitly gives the power to accept risk management models to the consolidating supervisor for all operations of the banking group within the EU, be it branches or subsidiaries;
- Existing directives about banking supervision already allow the supervisors of subsidiaries to delegate their supervisory tasks and responsibilities to the supervisor of the parent company, but unfortunately this principle has not yet been put into practice;
- CEBS is developing extensive work on how home and host supervisors should better work together. The consolidating supervisor has a coordination role to play between supervisors;
- For conglomerates and insurance groups, the role of a coordinating supervisor is poorly defined in the Insurance Groups Directive and the Financial Conglomerates Directive. CEIOPS have already advised the Commission on changes to bring the IGD more in line with the supervisory requirements of the FCD. These issues will be elements addressed in the planned revisions of the concerned directives. Solvency II should also bring greater supervisory convergence.

However, the framework is far from complete. Even within the CRD, host supervisors still retain the right to add supplementary requirements to subsidiaries in their country. It is not yet clear to what degree host supervisors will use (or misuse) this possibility, but it remains a possible threat to full consolidated supervision. The coordinating supervisor for conglomerates and insurance groups is essentially coordinating agendas, but not necessarily the content of supervision.

The Lamfalussy committees, and especially CEBS, have as a goal greater convergence and coherence in banking supervisory practice and the definition of EU-wide best practices, but these Committees have limited power to take decisions. Their conclusions can be compromises between 25 national supervisors, which can sometimes produce results significantly removed from market practice. The L3 committees are, however, well placed to play a key role as a catalyst in further improving supervision in the EU. The recent 3L3 Protocol agreement to cooperate in areas of common interest is an important development down that road.

An EU-wide coherent framework is necessary
An efficient and effective supervisory framework requires all elements of the safety network for banks to fit into an overall architecture in which all stakeholders understand their responsibilities and are able to act together. The EU clearly needs further analysis and reflection on this delicate issue.

One idea could be to organise the lender of last resort function along the same lines as prudential supervision, with one central bank taking the lead and coordinating through a "college" structure with the activities of other involved central banks in case of a crisis.

Deposit guarantee schemes should also be organised coherently. It should be recognised that ex-ante funded schemes do not necessarily have sufficient funds to cover problems at one of their big cross-border groups: in case of a real systemic crisis, governments always intervene. proper arrangements must be in place to ensure fast action in case of crisis that is necessary to restore confidence. Agreements between central banks, supervisors and treasuries do exist, but it needs to be ascertained whether the defined rules are clear enough to handle a major crisis efficiently.

The debate about the architecture of financial supervision should not lead to ideological debates but should instead focus on defining clear goals against which any alternatives can be measured. Ideally, these goals should be:
- financial stability and a competitive financial sector;
- cost effectiveness;
- creating a level playing field;
- transparency and boosting confidence;
- providing an effective framework for crisis management;
- fostering market integration and efficiency;
- providing clear political accountability.

Specific issues related to supervision of multi-jurisdictional operators of markets
The major difficulties arise from the existing disparities in the information and reporting requirements throughout Europe with respect to supervisory compliance. Differences in the way supervision is handled in the various EU countries in relation to factors which are uniform within an entity is also a major concern.

To solve such problems, cooperation and coordination between supervisors should be pushed to the greatest extent possible in dealing with markets whose structure is uniform across all the jurisdictions concerned. Where the market arrangements are identical across jurisdictions there should be a presumption of identical regulatory treatment, from which divergence needs to be justified. A minimum standard toolbox for regulators would for such purpose be helpful. Legal constraints that unduly limit cooperation and coordination should be eliminated.

For operators having several home supervisors, the concept of a "coordinating supervisor" would ensure that business was progressed without prejudicing the jurisdiction of each of the individual national regulators and reduce unnecessary regulatory complexity resulting from the existence of multiple competent national supervisors. In that regard, the setting up of practical arrangements to increase coordination at all levels (authorisation, control, sanctions) would be most useful.

Prudential supervision of Investment Firms
Many of the above comments are equally applicable to investment firms. However it should be emphasised that investment firms do not take deposits in the traditional sense, have no support from the Central Bank as the lender of last resort, and are not subject to Deposit Guarantee Schemes. Investment firm funding and liquidity management is very different to that of banks. Investment firms will usually have policies to restrict the proportion of illiquid assets on their balance sheet, will maintain a high degree of liquidity to ensure liabilities can be met as they fall due, especially in times of distressed markets, and will manage liquidity at the level of the group to maximise economies of scale, centralise funding and maintain the highest degree of liquidity for the group.

The primary prudential concern for supervisors of investment firms is the maintenance of stability in the financial market system. Should the activities of a larger investment firm be severely restricted, there is a danger that the financial markets could be significantly disrupted, decreasing liquidity in the market and consequently affecting the liquidity of other financial institutions including banks. It is therefore equally important for investment firm supervisors to adhere to the principles laid out above; namely that home/host regulators should work together under a coherent framework, recognising the importance of a lead regulator and the group nature of funding and liquidity management. In addition, given the international nature of the larger investment firms, the cross-border issues extend to countries outside of Europe, and therefore European supervisors should look to work closely with non-EU supervisors.

Conclusion

Cross-border financial institutions and operators of markets are essential for financial integration and growth in the EU. The prudential framework should follow market evolution and the only solution is a cross-border approach. Therefore the supervisory framework should be adapted. This should be a step-by-step, evolutionary process rather than a radical overhaul. For large international firms, a global framework would obviously be most helpful but we must resolve that which is within our scope first!

Briefing notes are prepared by the Financial Industry 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 Financial Industry Committee.

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