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## Internationalisation of banking and banking supervision

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# Research Notes in Economics & Statistics

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## Internationalisation of banking and banking supervision\*

- The divergence between increasingly supranational financial markets on the one hand and still largely national supervisory structures on the other gives rise to tensions which reduce the effectiveness of the supervision. It lies in the interests of both the public and the private sector that the supervisory structures are commensurate with the risks in a global capital market. An extension of the framework of common minimum standards (at a high level!) and joint definitions and data standards are just as essential as an intensification of cooperation among the supervisory authorities. Self-regulation, market discipline and the inclusion of the financial industry in the shaping of the rules should be obvious elements of a modern supervisory regime.
- Banks which operate internationally see themselves caught between national regulation and cross-border activity every day. The combination of different sets of rules and supervisory authorities is a major cost factor and hinders the integration of the markets. The co-existence of national authorities operating in parallel risks violates the principle of competitive neutrality of supervision in a single market. This certainly applies in the EU, where not only internationalisation, but supranationalisation of supervision is called for.

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## **1. Introduction**

The two forms of internationalisation stated in the title are progressing at different paces, so a more fitting title would be "The internationalisation of banking and the lack of internationalisation of banking supervision". The divergence between increasingly supranational financial markets on the one hand and still largely national supervisory structures on the other gives rise to tensions which reduce the effectiveness of the supervision.<sup>1</sup> It lies in the interests of both the public and the private sector that the supervisory structures are commensurate with the risks in a global capital market.

Banks which operate internationally see themselves caught between national regulation and cross-border activity every day. They are confronted with myriad national and international regulations and a host of national supervisory bodies. But this combination of different sets of rules and supervisory authorities is a major cost factor and hinders the integration of the markets. The co-existence of national authorities operating in parallel risks violating the principle of competitive neutrality of supervision in a single market. This certainly applies in the EU, where not only internationalisation, but supranationalisation of supervision is called for.

## **2. Requirements for efficient supervision**

Efficient supervision must fulfil the following conditions:

- Integrated markets require integrated supervision – in terms of content and geography. The lead supervisor must be identified, exchanges of information guaranteed, and concerted action organised for times of crisis.
- The supervisory authority must be close to the market, i.e. able to respond to market changes, and must not obstruct innovation.
- The principle "same risk, same regulation" has to apply, i.e. supervision must have a neutral effect on competition. This holds on the one hand for competitive neutrality in comparisons with other countries, and on the other for neutrality between financial institutions from different sectors.

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<sup>1</sup> See Breuer, Rolf-E. (2000): Regulation and banking supervision: Caught between the nation state and global financial markets, in: Deutsche Bank Research, EMU Watch, June 29, 2000, Frankfurt/Main.

- The costs must stand in relation to the benefits: a fragmented supervisory structure leads to considerable expenditure for internationally operating companies since they have to report to numerous authorities.

### **3. The internationalisation of banking**

The ties between financial markets and between financial institutions are increasing – across borders and sectors alike. (Given the cross-sector integration it is more correct to speak of "financial supervision" than "banking supervision", since a supervisory system that is divided strictly along market segments can no longer effectively guarantee the stability of the financial system.) The related emergence of deeper, more liquid financial markets contributes in principle to stabilisation. The broader diversification of the business partners and greater liquidity reduce risks; liquidity bottlenecks in an individual market segment can be handled better. Institutional arrangements which have developed over the years are also stabilising factors, e.g. the broader recognition of netting arrangements, the spread of securitised transactions, greater transparency and the increasing use of efficient risk-management systems. In the EU the development of real-time large-value payment systems has contributed greatly towards reducing credit and settlement risks in the interbank market.

There are no generally accepted key figures that could be used to prove beyond doubt that banking has gone international. However, taken together, a number of indicators confirm the general impression of an increasing degree of integration in the banking and financial markets:

- Business dealings between German banks and foreign customers – whether on the deposit or the lending side, banks or non-banks – have been growing faster than domestic business since 1995.
- In most (European) countries, foreign banks claim a minor share of the market, i.e. usually less than 10% of total banking assets (exceptions: Belgium, Ireland, the United Kingdom and Luxembourg). But on the other side of the coin: the assets of the foreign subsidiaries and branches of German and French banks are

already equivalent to over one-third of the assets of the respective home-country banking systems.<sup>2</sup>

- Cross-border M&As accounted for one-fifth of all M&As in the financial sector (in terms of volume and number) in the past decade.
- Regional breakdown of the institutions' revenues: the top 50 banks in Europe generated 67% of their business in their home market in 1998, 15% in the rest of Europe and 18% elsewhere. In other words, one-third of revenues is generated abroad.<sup>3</sup>
- Capital market business: the lead managers in equity and bond issuance are international players. Back in 1995, companies chose a lead manager from their home country for 81% of the corporate bonds they issued in the home currency; this figure was down to only 36.2% in 2000.
- Euroland has seen the emergence of an integrated money market with common benchmarks. Some 50% of the transaction volume in the money and repo markets involves foreign counterparties.

But what is perhaps more remarkable than the process of internationalisation alone is the concentration of business in a small number of ever larger and more complex institutions. These institutions are each other's most important counterparties; they have overlapping client bases, and in many cases own stakes in stock exchanges, other trading platforms or settlement systems – they are, in other words, linked with one another in a complex way.<sup>4</sup>

#### **4. Potential risks of strongly integrated markets**

The result of the changes is a financial market which features market integration and a consolidation of institutions across product and geographical borders alike. However, this in itself positive development went hand in hand with the emergence of a series of potential and concrete risks:

- Internationalisation can potentially lead to market entry by institutions from countries with inadequate supervision.

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<sup>2</sup> See Padoa-Schioppa, Tommaso (2000): EMU and Banking Supervision; in: Goodhart, C. A. E.: Which lender of last resort for Europe?, London, pp. 13-29.

<sup>3</sup> See Report on Financial Stability (2000), ("Brouwer Report"), EU Economic Papers, No. 143, May, Brussels.

<sup>4</sup> See Group of Thirty (1997): Global Institutions, National Supervision and Systemic Risk, Washington, D.C.

- Internationalisation results in overlapping spheres of competence among the national supervisory authorities. The job of monitoring the activities of internationally operating institutions in the different market segments must be assigned to a clearly identified party.
- In the course of consolidation, institutions may develop that are so large that they represent a systemic risk.
- A higher level of integration raises the danger of risk spill-over. The institutions themselves and the mechanisms which connect them with one another (payment and settlement systems) are sources of instability. The integration of the interbank markets is the most likely source of a spill-over of liquidity risks. Systemic risk is particularly pronounced there because deals are done with unsecured funds – particularly in overnight transactions.<sup>5</sup>
- Moreover: in integrated capital markets the institutions are exposed to risks which arise outside the borders of their home market, and the risks to financial-market stability are confined less and less to national markets. One example is the LTCM crisis in autumn 1998 – a risk which developed outside the European market but which impacted the whole of the international capital market. This means that even banks which operate solely on a national basis are influenced by events that take place outside the nation's borders.<sup>6</sup>
- At the same time, the integration of the markets has led to a shortening of the time needed for reaction. This stems especially from the fact that crises in financial systems today increasingly develop in the capital markets and thus spread rapidly; by contrast, credit risks are the dominant factor in bank-based systems and they usually unfold more slowly.

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<sup>5</sup> The reason for the dominance of unsecured money-market transactions is that the differences in the documentation and quality of collateral hinder the development of a cross-border repo market. The "collateral directive", which is to create legal uniformity EU-wide in this regard, has been deadlocked for several years. The poor progress in harmonising legal issues in the European financial market thus creates unnecessary risks. Over 50% of the transactions in the Euroland interbank market are unsecured, and in the overnight market as many as 75%. One consequence is a further concentration of business on a few houses, since this, from the standpoint of each individual bank, lessens the associated risk. The 20 biggest banks now account for 40% of the total Euroland interbank market.

<sup>6</sup> See Duisenberg, Willem F. (2000): The future of banking supervision and the integration of financial markets; speech at the conference "Improving integration of financial markets in Europe", Turin, May 22; available at <http://www.ecb.int/key/00/sp000522.htm>. The frequently heard argument that only the development of pan-European banks will compel people to think about European banking supervision obviously does not hold water.

## **5. The internationalisation of banking supervision – the institutional side**

When analysing the internationalisation of banking supervision it makes sense to differentiate between changes in the institutional arrangements (rules and official bodies) and changes in actual practice. Internationalisation has made greater advances in the former than in the latter.

The institutional aspect is reflected at the international level by the Basel Committee on Banking Supervision, established in 1974, and its counterparts for securities trading (IOSCO, 1983) and insurance undertakings (IAIS, 1994). These bodies have no supervisory powers of their own; their purpose is to set international standards and coordinate the work of national regulators. Examples for the banking sector are the Basel Accord of 1988 which sets out a capital-adequacy framework and the Core Principles of Effective Banking Supervision (1997). The Basel Committee's objective is to ensure that no internationally operating bank works without effective supervision, that all have adequate capital, and that market discipline can hold sway.<sup>7</sup> The first target falls under the relevant agreements on the role of home-country and host-country supervisors: the regulations on consolidated supervision. The second target is covered by the Basel minimum capital standard. Rules on disclosure requirements are means to achieve the third target. The Basel Committee moreover seeks to create a level playing-field and lessen incentives for regulatory arbitrage.

The work of the above-mentioned committees in Basel, typically, is "soft law"; i.e. the recommendations produced originate from cooperation among supervisory authorities, not internationally binding regulations which stem from intergovernmental agreements or normative work by international organisations. The success of the committees' work thus hinges on the participating authorities' managing to have their recommendations followed in practice, becoming market standards, and on the scope of application being large enough to encompass the bulk of international financial business.

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<sup>7</sup> See Padoa-Schioppa, Tommaso (1997): Market-friendly Regulation of Banks: an International Perspective, in: Duwendag, Dieter (ed.): Szenarien der EWU und der Bankenregulierung, Schriften des Vereins für Socialpolitik, No. 248, Berlin, pp. 117-130.

In the European Union the institutional arrangements<sup>8</sup> are based on the relevant directives (including the First and Second Banking Directives, "BCCI Directive", and the Capital Adequacy Directive), which provide a broad framework of harmonised minimum standards. These standards form the basis for the principles of home-country control and mutual recognition as well as cooperation among the supervisory authorities in monitoring cross-border activities. Cooperative practice is based on bilateral memoranda of understanding (MoUs), which are to establish clarity as to the respective cross-border competencies. MoUs look after practical issues such as cooperation on local investigations. (In addition, the Treaty on European Union provides that the Eurosystem, which itself has no powers in the context of banking supervision, helps to ensure a smooth process of supervision by the authorised bodies.)

The bilateral consultations are supplemented by exchanges of information in multilateral bodies:

- The *Groupe de Contact*, an informal forum of banking supervisors, in which knowledge about individual institutions and general market developments is exchanged;
- The Banking Supervision Committee, installed by the General Council of the ESCB with the mandate (1) to assist the ESCB as consultant when it considers measures to stabilise the financial system and (2) to form a multilateral forum for information exchanges;
- The Banking Advisory Committee, in which representatives of the finance ministries, the supervisory authorities and the central banks advise the Commission on issues of European legislation, to the extent it involves supervisory matters;
- FESCO (Forum of European Securities Commissions), which in the area of securities markets increasingly functions as consulting body for new sets of rules, but not as a platform for exchanges of information on individual institutions.

Within the EU, greater cooperation is sought than the level of global cooperation targeted in the context of the Basel-based committees: the EU goes beyond the Basel target in aspiring to create the prerequisites for a truly integrated, single

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<sup>8</sup> See CEPS (2000): Challenges to the Structure of Financial Supervision in the EU, Brussels, p. 11ff.



financial market also in supervisory terms. The situation in the EU differs from that internationally in that the minimum requirements for the supervisory authorities and the cooperation of the respective bodies are legally binding, i.e. not "soft" law, but "hard".

There is a need for further standardisation of the legal foundations of supervision and regulation – at the global as well as the European level. What causes problems is that these processes take far too much time. Thus, the current regime does not fulfil the requirements, stated at the outset, for an efficient supervisory system (close to the market and open to innovation). "Basel II", the revision process for capital standards which has been under way for years, illustrates this just as well as the difficulties the EU has had to implement the Financial Services Action Plan (FSAP)<sup>9</sup> on schedule. The recent report of the Lamfalussy Group<sup>10</sup> dealt at length with this problem of long and complex legislative procedures; the statements made about the EU's securities markets can easily be applied to banking supervision, also the situation at global level. In a sector which witnesses such rapid innovation and change as the financial-services sector, the regulatory framework has to be swiftly adaptable so the gap to market practice does not become too great. What is even more important than the speed of legislation is flexibility: it must be possible to make adjustments to technical details which have no bearing on the basic philosophy of a regulation, but make a major difference in terms of its economic effect.<sup>11</sup>

## **6. Are the current structures viable for the future?**

The current regime has done a fair job – at least as regards maintaining systemic stability. Major crises have been avoided or resolved through ad hoc cooperation. The response to the ongoing internationalisation of banking so far has mainly been to intensify the cross-border cooperation between the supervisory authorities.

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<sup>9</sup> European Commission (1999): Financial Services: Implementing the Framework for Financial Markets: Action Plan; COM(1999)232, Brussels.

<sup>10</sup> See Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (2001), Brussels.

<sup>11</sup> One example is the calibration of the benchmark risk-weight function in the internal ratings approach of Basel II. Since the effect of this function is difficult to assess "in the laboratory", it must be possible after the introduction of Basel II to swiftly change the calibration as necessary in the light of the experience gained. This would not be possible if the whole of Basel II were cast in the form of a directive.

However, it is doubtful whether mere cooperation will suffice in future given the scope of integration. The system functioned properly when the markets were not integrated all that deeply, but with ever closer ties between institutions and markets it is starting to display unmistakable weaknesses. These are to be shown in the following using the EU as an example, since in this region the discrepancy between the internationalisation of the financial markets and the internationalisation of the largely national supervisory structures is particularly visible. Moreover, the situation in Europe is unique by virtue of the fact that the effective area of monetary policy is no longer identical with the area under supervisory control. The Treaty on European Union refers to the subject of banking and financial supervision in only cursory form; there is no provision on the division of labour among the numerous parties involved in the supervisory process. The EU thus lacks an institution which has an eye on financial market stability not only in different market segments (or even just one market segment), but in the euro area as a whole.

The European institutions (Commission, ECB, supervisory authorities) and the member states so far concur that this arrangement provides a basis that is adequate and flexible enough to guarantee the stability of the financial system in future. However, an intensification of the cooperation between the supervisory authorities is deemed sensible and necessary to secure effective supervision and the ability to respond rapidly in times of crisis. According to the recommendations of the Brouwer Report<sup>12</sup> all that is necessary is improved cooperation in practice. In concrete terms:

- Strengthening of international cooperation also across sectors (so far only cooperation within the respective silo);
- Better exchanges via the large, systemically important institutions;
- Improvement of the dialogue via statutory measures and regulatory requirements;
- Harmonisation of supervisory practices;
- Securing the participation of the central banks.

Others, like the IMF<sup>13</sup>, do not share this opinion, and are instead concerned about whether the regime is appropriate for an integrated financial market. No matter how great one might consider the risk to ensuring systemic stability, the current structure

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<sup>12</sup> See Report on Financial Stability (2000), loc. cit.

<sup>13</sup> See IMF (1998) Capital Markets Report, September 1998, Washington, D.C., p. 105 ff.

in any event violates the other targets that a supervisory system is also supposed to fulfil: efficiency, flexibility towards innovation and, especially, competitive neutrality.<sup>14</sup> Moreover, the current structure obstructs the creation of a truly integrated, single financial market.<sup>15</sup> It is correct that the regulatory framework should not, if at all possible, trigger structural changes in the financial system; however, it should not deviate from market practice or hinder the development of the financial system either.

## **7. The weaknesses of the current system**

The weaknesses of the current supervisory system are as follows:

### a) Quality of supervision

Even if there were standard rules, uniform implementation would only be guaranteed if all the supervisory authorities enjoyed equal powers and competence. This is not the case.<sup>16</sup> Furthermore, competitive distortions can arise in precisely such an innovative sector as financial services because of the fact that supervisory authorities react differently and/or at different speeds to new developments.

### b) Non-harmonised legal foundations

Non-harmonised rules and regulations are a source of competitive distortions in a single market, and particularly if the principle of mutual recognition does not, or cannot, apply. Here are two examples to illustrate. The principle of home-country control generally does not apply in respect of the protection of private consumers, but the consumer protection rules of the country in which the consumer lives do apply.

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<sup>14</sup> Interestingly enough, in the Brouwer Report these shortcomings are also conceded by the supervisory authorities, but not deemed so important; see Report on Financial Stability, loc. cit., p.15.

<sup>15</sup> See CEPS (2001): EU Securities Market Regulation – Adapting to the Needs of a Single Capital Market, Brussels.

<sup>16</sup> It is worth noting that, unlike the position of the supervisory authorities, legal equality of all the national central banks was considered a prerequisite for EMU, and a corresponding regulation, Art. 109 (new), was included in the Treaty on European Union.

So institutions that want to offer their products in all the EU states are compelled to comply with 15 different regimes.<sup>17</sup>

There is no standard procedure for handling M&As in the financial sector in the member states. The investigation procedures differ as much as the involved authorities and the criteria which are applied in the examination.<sup>18</sup> Here it is particularly obvious that different customs are a barrier to the creation of a single financial market.

### c) Uneven implementation

Distortions arise not only because of non-harmonised rules and regulations, but also because of the uneven implementation of EU rules. Due to the discretionary scope left to the national supervisory authorities by the EU's legal statutes, supervision is not uniform in practice.<sup>19</sup> Indeed, the remaining latitude is used by the national governments – whether deliberately or not – to protect national markets. This results in regulatory arbitrage and competitive distortions. It is a largely ignored message of the Lamfalussy report that was lost in the dispute over comitology that the single European market for financial services has failed to take off partly because of this inconsistent implementation of Community law. That is why the Group of Wise Men demands a harmonisation of supervisory practices ("level 3") and rigorous moves by the Commission when member states contravene the letter and spirit of EU regulations ("level 4").<sup>20</sup>

The fundamental reason for the differences in supervisory practice is different philosophies as regards targets: the national governments and supervisory authorities attach quite dissimilar significance to the sub-targets stability, efficiency, consumer protection, protection of the domestic financial industry and promotion of

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<sup>17</sup> Given that financial services are goods based on trust, no doubts are expressed about the need for efficient consumer protection. However, it is doubtful that the existing system really acts in the consumer's interest. It results in the consumer being offered much less than the full product spectrum and sets limits on growth opportunities in Europe. Given the relatively high level of consumer protection in all the EU states and in the light of fundamental "caveat emptor" considerations, it seems to make little sense to stick to the current system. Alternatively, more thought could be given to whether consumer protection might not be better dealt with using other, less distortive models (e.g. ombudsperson rules).

<sup>18</sup> See Speyer, Bernhard and Kirsten Wandschneider (1999): M&A rules in Europe's banking industry: a need for reform?, in: Deutsche Bank Research, Frankfurt Voice, August 23, 1999, pp. 17-21.

<sup>19</sup> See European Central Bank (2000b): EMU and banking supervision, in: Monthly Bulletin April 2000, pp. 49-64.

<sup>20</sup> See Final report (...) (2001), loc. cit.

national financial centres. Therefore, there have been repeated calls – also voiced recently in the Lamfalussy Group's report – for a framework directive that would establish a common understanding of the objectives of financial supervision.

A certain degree of flexibility is undisputedly needed when interpreting the law so the particularities of individual national banking markets can be taken into proper consideration. The practices – both in daily work and in handling crisis situations<sup>21</sup> – vary considerably, though. In fact, they differ so much that competitive neutrality of supervision would not seem to be guaranteed in a single market.

#### d) Inefficiency of supervision

Given that the principle of home-country control is not applied consistently, internationally active institutions are obliged in practice to report to the supervisory authorities of all the countries in which they do business. In the EU this means 15 in the extreme case, and for most banks Switzerland has to be included (Deutsche Bank, for instance, reports to no less than 20 supervisory authorities across Europe).

Besides the fact that the parallel functions of national supervisory systems produce unnecessary welfare losses, they also endanger the neutrality of supervision as regards competition between institutions of different size. Large financial institutions are able to afford the additional costs of coordinating their business activities with fifteen or more supervisory authorities, but this does not pay in the case of smaller institutions. The inappropriate structure of banking supervision is therefore an additional driver of the consolidation trends in the financial sector.

#### e) Inconsistent rules for consolidation

Owing to the different treatment of subsidiaries and branch offices within the EEA, the structure of home-country and host-country control makes consolidated supervision of the activities of internationally active institutions more difficult. Branch offices are subject to home-country control, but subsidiaries are monitored by the respective authority of the host country. At the same time, though, the home supervisor (in accordance with the directive on supervision on a consolidated basis of

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<sup>21</sup> Compare, for example, the approaches of the competent authorities in the Barings and Crédit Lyonnais cases.

credit institutions) is obliged to scrutinise the stability of the consolidated group – in which, of course, the subsidiaries also have to be included.

This is a problem in particular for the supervisory authorities of small countries with internationally active institutions, since in this case it can easily happen that much of the institutions' business may be conducted outside the home country. The more cross-border an institution's activities, the less credible the claim of national supervisory authorities that they are better informed due to their closer proximity to the regulated institution. At the same time, the host-country supervisor faces the problem that the maintenance of systemic stability is the job of the respective national authorities – but they do not have all the necessary information in cases when a significant part of the financial sector is made up of branch offices of foreign institutions or cross-border product offers.

#### f) False incentive structure for cooperation

The parallel functions between home-country and host-country control are not only a potential source of inefficiency due to overlapping areas of responsibility. What has graver consequences is that they can set erroneous incentives in respect of the seamless supervision of the institutions.<sup>22</sup> Since the mandate of the supervisory authorities, beyond the general formula of an obligation to cooperate, is not clearly specified and, on a self-defined basis, tends to be oriented to the vested interests of the host country, there is no guarantee that all the information necessary to exercise full control will actually change hands.

The home-country supervisor may be tempted to neglect checking the foreign subsidiaries as long as they represent a negligible fraction of an institution's overall activities. Conversely, the host supervisors have an incentive problem in that ultimate control lies with the respective home-country supervisor and a detailed examination may appear unnecessary particularly when the activities of the foreign institution are small in comparison with the overall volume of the home banking market. Both cases must be considered conceivable not least in the light of the scarcity of supervisory resources.

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<sup>22</sup> See Enria, Andrea and Jukka Vesala (2001): Externalities in financial supervision: The European case, in: Kremers, J.J.M. et al.: Financial Supervision in Europe (due to be published in spring 2002).

It is equally doubtful whether there are sufficient incentives to pass on information and whether cooperation is actively sought. The experience gained in the G-10 instead shows that the sharing of responsibility between home-country and host-country authorities does not always work smoothly.<sup>23</sup> The current arrangements – including the MoUs – do not offer sufficient incentives. Rather, home-country supervisors may be tempted to keep the knowledge of problems from the host supervisors; firstly, to cover their own failure, and secondly, to avoid a further destabilisation of the affected institution owing to additional problems on foreign markets. Thirdly, the home-country supervisors bear no direct, and thus sanctionable, responsibility for the stability of other markets. In fact, they actually have more of an incentive to be uncooperative; one example might be to demand that the affected institution withdraw funds from abroad and use them to help stabilise the domestic businesses in order to keep losses in the domestic economy to a minimum.<sup>24</sup> At the root of the matter is the fact that the home supervisor has a national mandate, so its action is naturally influenced by the effects on the home market.

The MoUs do not resolve this conflict. They contain no rules on regular exchanges of information on general market developments; they have no rules on scale and content of communication in crisis situations and do not include arrangements for consultation on the internalisation of external effects in times of crisis.

#### g) Europe's voice in the world

One special aspect regarding the sense of strengthening harmonisation specifically in the EU deserves mention: the structure of financial supervision is a competition factor. Regulations for the financial sector are increasingly the subject of international negotiations. The solutions attained are more and more often not purely technical, but increasingly political in nature. If and when it is possible to push through a national standard worldwide, the result is a competitive advantage – at least temporarily – for financial institutions in the respective home market. A common European voice would have more weight in international bargaining on supervisory

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<sup>23</sup> See Prati, Alessandro und Garry Schinasi (2000): Will the European Central Bank be the lender of last resort in EMU?, in: Artis, Michael et al.: The Euro – A challenge and opportunity for financial markets; London, pp. 227-256, here: p. 227.

issues. The Europeans' difficulties in formulating a uniform position mean that justified European interests are at times not stated clearly enough in international fora and are frequently heeded too late.

### **8. Objective: a European financial supervisor!**

The principles of home-country control, minimum harmonisation and mutual recognition are suitable for a structure which is marked by increasing, but not major, market integration. It eliminates the biggest differences and creates an incentive towards further harmonisation through regulatory arbitrage of the regulated entities. However, a truly integrated single European market for financial services cannot be achieved with the existing, fragmented supervisory regime. The obstacles blocking the way to the realisation of the single financial market and the resulting welfare losses are so large that action at the European level appears to be justified and called for.

The solution favoured by official Europe – tighter cooperation – would be helpful, but not enough. One may naturally hope that increased coordination, and some harmonisation of the supervisory practices, will eliminate the biggest weaknesses of the current system. However, the effect will remain limited. First of all, mere coordination will do nothing to change the fundamental problem, namely the co-existence of different national authorities in a single currency area, meaning that the problems of inconsistent implementation and inefficiency will remain. Second, national authorities have a mandate which naturally relates to their respective legal territory and financial market. They must not, and cannot, assume a European perspective in their work if and when this conflicts with national interests. Third, only by delegating supervisory powers to a supranational institution will it be possible to ensure uniform treatment, as this is the only way a higher-ranking, authoritative body can emerge. Otherwise, harmonised treatment would only be securable if the Commission took the matter to the European Court of Justice (as in the Champalimaud case). But the Commission only resorts to this method in exceptional cases. It is unlikely that the private sector will vehemently attack the poor state of affairs, so it is also unlikely that a change will be forthcoming via this channel.

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<sup>24</sup> The greater the difference in the size of the relevant countries, the greater the difference in the



Therefore, a European supervisory authority will be inevitable in the medium term.<sup>25</sup> Compared with the status quo the new regime would feature a larger framework of common rules, lower coordination costs, greater flexibility and market proximity. In institutional terms, the single European authority should be independent, i.e. not part of the Commission. It should have the decentralised structure of the Eurosystem, i.e. central instruction and decision powers combined with a decentralised organisation, so the knowledge of the national supervisory authorities can be tapped to understand the peculiarities of the local markets.<sup>26</sup> It goes without saying that a shift of supervision to the supranational level must not result in a lowering of standards. Moreover, it must be guaranteed that the supranational institution has an appropriate degree of transparency.

## **9. The prospects of a European financial supervisor**

Is there much likelihood of state sovereignty being delegated to a supranational supervisory authority? In principle, the European states have proven in another area – competition policy – that they are capable of delegating such tasks. The reason, given explicitly, is to maintain competitive neutrality in the single market.

But this type of courageous step towards a European financial authority is predicated on a common basic understanding of the goals of financial supervision, the weighting of the sub-targets and, naturally, the will to create a genuine single market for financial services.

It is, at the same time, clear that a host of serious content issues would need to be clarified. Let us look at just one as an example. Each supervisor exercises a sovereign function and must therefore render account of its actions and submit to democratic control – especially in light of the fact that the work of the financial supervisor can have grave fiscal implications. But to whom would a European financial supervisor be liable? Who should decide on the international division of

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incentive structures.

<sup>25</sup> See Breuer, Rolf-E. (2000): Convergence of supervisory practices – a banker's view; speech given at the Conference of European Banking Supervisors, Copenhagen, November 20, 2000; available at <http://www.ftnet.dk/frame.asp?documentID=758&menuID=40>

<sup>26</sup> For a similar proposal see Di Giorgio, Giorgio et al. (2000): Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area; Wharton Financial Institutions Center, working paper 00-24.

burdens after a ruling by the supervisory authority in cases where institutions operate in several EU member states?

So far, admittedly, none of the affected major institutions or players in the public sector have commented positively on the plan to create a European supervisor. Therefore, presumably quite some time will pass before this topic appears on the official agenda.

#### **10. On the management of financial crises in Euroland**

Criticism of the current system of financial supervision in Euroland is usually focused not on the aspects stated above, but instead on the issue of crisis management. Since this has been discussed in detail elsewhere<sup>27</sup>, it is only mentioned in passing here. The official arrangement is that national central banks can continue to fulfil the function of lender of last resort.<sup>28</sup> The costs and risks of such measures thus remain with the national authorities. The prerequisite is that the measures are reconcilable with the monetary targets of the Eurosystem and that the cross-border effects are taken into consideration. It follows logically from these two prerequisites that the Eurosystem has to be informed of developments, in good time and in detail. State aid to an individual institution or institutions will be subject to the general aid rules of the Treaty on European Union, which place limits on such support measures.

All the same, this still fails to answer how a crisis facing an internationally active institution would be handled. Who will assume the leadership role; who will coordinate events; and, especially, who will bear the costs? Will reactions be swift enough? In the past, ad hoc crisis management dominated the scene. A certain degree of discretionary action will invariably be required to deal with the specific characteristics of a given crisis. Nevertheless, the present system leaves the impression on some observers not of constructive, but rather of unsettling ambiguity.

#### **11. Instruments to supplement the traditional supervisory tools**

Besides the institutional changes the internationalisation of banking requires a re-weighting of the supervisory instruments and new forms for the origination of regulatory arrangements.

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<sup>27</sup> See Prati/Schinasi (2000), loc. cit.

<sup>28</sup> See Padoa-Schioppa, Tommaso (2000), loc. cit.

The complexity of banking makes it necessary to use not only the traditional instruments of supervision but also other mechanisms, especially self-regulation and market discipline. In this respect, the new Basel Capital Accord with its interactive three-pillar concept, which assigns an explicit role to the third pillar, market discipline, is a move in the right direction. Generally, the shift away from rule-based supervision after the fact towards process-oriented supervision is the proper approach.<sup>29</sup> The risk position of an international operator, or in fact any institution, changes so rapidly that ongoing supervision is not possible using *ex post* figures. It therefore makes sense to check the quality of the banks' internal risk management systems instead of the actual risk position. This must go hand in hand with the possibility for the other market participants and the institution's creditors to exercise a control function. To do so they require, firstly, sufficient up-to-date information, and secondly, economic incentives to use this information and act on it. The latter is only guaranteed if the sanction mechanism of the market remains in place.

Complexity is not only an argument for enhancing the role of market discipline, but also for including the regulated institutions when formulating the rules. Complex sets of rules, such as Basel II, require the input of the institutions since this is the only way to create a regulatory arrangement that pays adequate attention to market practice. This is not a case of "regulatory capture", in which the regulator is reduced to being the industry's official mouthpiece, but the result of the mutual desire to apply the best practices and achieve consistency between rules and market practice.

## **12. Conclusion**

Greater internationalisation of banking supervision is a logical and necessary consequence of the internationalisation of banking business. A global capital market must, in the interests of all parties (not least the financial institutions themselves), show no gaps at the supervisory level. An extension of the framework of common minimum standards (at a high level!) and joint definitions and data standards are just as essential as an intensification of cooperation among the supervisory authorities. Not least, this requires providing the supervisors with adequate financial resources.

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<sup>29</sup> For a discussion of rule-based vs. process-oriented supervision in the context of Basel II see also Karacadag, Cem and Michael W. Taylor (2000): The New Capital Adequacy Framework – Institutional Constraints and Incentive Structures, SUERF Studies No. 8, Vienna, pp. 18-20.

Self-regulation, market discipline and the inclusion of the financial industry in the shaping of the rules should be obvious elements of a modern supervisory regime.

However, more determined action is required, especially in Europe: it makes little sense to have a single monetary policy and to aim for a single financial market while at the same time retaining differing regulatory and supervisory structures. It is amazing that people in the EU are not prepared to accept the logical consequences connected with the creation of EMU. Europe found the strength to launch the Monetary Union, but is now reluctant to take the accompanying steps to create a single market for financial services in its wake.

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