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EU Regulatory and Supervisory Convergence: The case for a dual system with choice

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EXECUTIVE SUMMARY

Pressure for further convergence of European financial sector supervision continues to mount. There is still considerable opposition to further integration. But debate is nevertheless increasingly focused on what form further integration should take. This paper contributes to this debate by discussing the advantages of a dual system that provides financial institutions with a choice between national and European level regulation and supervision.

A dual system with choice could facilitate the emergence of specialised supervisors and regulatory models that promote diversity and competition between financial institutions' business models. This would provide a much needed boost to the process of integration and could help to shift the fault lines of competition away from national borders towards trans-national market segments.

At the same time, it would address concerns that a dual model without choice might create a sort of "regulatory apartheid" system of internationally active institutions and more locally focused banks. Lastly, it would strengthen mutual recognition and provide reassurances to those that fear a European authority might hamper innovation and compromise the growth of EU's important financial centre in London.

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I. INTRODUCTION

Support seems to be growing for some form of European financial services authority(ies) (EFSA)[1] both as a means to re-vitalise the integration process and to strengthen prudential supervision. Many still oppose it, arguing that the current institutional framework is already on its way towards achieving the same objectives but with less bureaucratic fanfare and political conflict. Some also claim that the benefits of the status quo outweigh the implementation risks and practical challenges of establishing an EFSA. Nevertheless, there is already discussion not just about whether we need a European supervisory authority but also what form it might take. This paper contributes to this debate by outlining the benefits of a two-tier, or dual system[2], of European supervision and more specifically the merits of a dual system that offers financial institutions the choice between national and European regulation and supervision[3]. The paper explains how a dual system would address many of the legitimate concerns expressed about supervisory convergence and the possible creation of European supervisory authorities – either in a consolidated a form or along the lines of market segmentation.

Although a lot of attention has focused on the importance of supervisory integration, public debate on the alternative structures for a form of unified supervision in Europe has been limited. The recent so-called "Himalaya report" from the Committee of European Securities Regulators (CESR) avoided any explicit reference to the need for an independent European supervisory authority or regulator. But the underlying debate exists none the less and many public comments from market participants increasingly support more ambitious convergence[4]. Beyond the status quo, ideas for integration include the extension of Lamfalussy committee powers, development of the "lead regulator" model[5] and a centralised system of European supervision acting through national regulators in a way akin to the European System of Central Banks (ESCB). Increasingly there also seems to be interest in forming a special supervisory structure for internationally active financial conglomerates[6] – what one might call

[1] For ease of exposition I refer hereafter to EFSA, without specifying one or many authorities or their scope, an issue which is discussed later.
[2] Sometimes also referred to as a "two-tier" system, especially when citing the US structure of state and federal supervisors
[3] There is a distinction between "regulation" and "supervision". Regulation refers to legislative functions: the power to either set or interpret laws, rules and guidelines applicable to authorised institutions. Supervision refers to the powers to monitor the activities of regulated institutions and enforce regulations, rules and laws. However, to the extent that most supervisors in the EU have some powers of "regulation", unless otherwise stated, in the rest of this paper, the term "supervision" should be understood as entailing some degree of regulatory powers.
[4] See their responses to the Commission's Green Paper on financial sector policy (2005-2010)
[5] Support for this model has, for example, been expressed by the European Financial Services Round Table and the European Banking Federation
[6] See for example statements in favour, by Deutsche Bank, and against, by the European Savings Bank Group, in their respective responses to the Commission's Green Paper on Financial Services Policy (2005-2010). This

a two class system, or more negatively might be cast as a system of "regulatory apartheid" - but there has been little mention of a dual system that would provide scope for choice between regulation and supervision by an EU authority or by national supervisors[7,8].

There are several advantages of a dual system with choice. It would provide a new stimulus to integration and respond to calls by international groups for consolidated supervision across Europe. At the same time it would provide some assurances to small and local banks that they would not be marginalised and to those that fear that a single European supervisor might be too protectionist or interventionist, putting the success of London's financial centre at risk. It would not only preserve scope for regulatory competition in the EU but might improve upon it by shifting the fault lines of supervision from national boundaries towards pan-European market segments. Lastly, in so far as it is politically palatable, it may facilitate an acceleration of the institutional integration process, thus alleviating one of the biggest disadvantages for continental financial markets: the costs of further delay to integration and reform.

The rest of the paper is structured as follows: the next section provides some background on the general current arrangements in the EU. The second section outlines some reasons for scepticism about whether such arrangements are sufficient to achieve policy objectives. The third section then introduces the concept of a dual system of regulation and supervision for European financial markets and discusses some of its key advantages. The final section provides a summary.

II. BACKGROUND

The EU has already achieved a significant degree of supervisory convergence and harmonisation of regulation. But it has stopped short of any direct transfer of national supervisory powers to a new European institution. The current supervisory structure is characterised by the principles of home or host control and mutual recognition as well as the

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idea also found favour, in general international context, in a recent report from the US Government Accountability Office: See the Government Accountability Office (2004)

[7] These arrangements would not eliminate scope for financial institutions to switch from their historical supervisor to another national authority.

[8] Some references have been made to the idea of a "two-tier" system, but this also seems to imply little scope for choice. See Grünbichler and Darlap (2003), Schoenmaker 1995 as well as the EFAG Report 2003

increasing importance of the Lamfalussy Committees[9]. Legislative harmonisation, mostly in the form of the Financial Services Action Plan (FSAP)[10] also plays an important role in current arrangements to support both regulatory and supervisory convergence.

The system of home/host regulation is meant to simplify supervision for financial institutions and clarify the allocation of responsibilities between supervisors in different countries. With freedom of establishment across the EU, banks and other financial institutions can in principle operate abroad – as branches - under the authorisation and surveillance of their "home regulator". But as most financial institutions operate abroad as subsidiaries (and are thereby regulated locally), the concept has also been extended to the idea of a "lead regulator", implying that a group of financial institutions should have one supervisor – in principle their "home" regulator - in Europe that is responsible for coordinating a global overview of that institutions' activities (at least in Europe) and taking a *lead* in its supervision. There are numerous practical problems associated with the lead supervisor model in Europe[11]. Nevertheless there are increasing calls by industry to strengthen and extend arrangements for "lead supervision"[12].

Mutual recognition is a key principle on which the home/host structure also depends. By allowing branches of foreign regulated banks to operate locally, authorities implicitly recognise the equivalence of home countries' regulatory and supervisory frameworks to their own. In principle this allows at the margins for some form of regulatory competition and choice. Some institutions, in particular investment banks, seem to have taken advantage of this freedom, operating in many countries as branches of a London based institution, using a so-called "hub and spoke" model. Many institutions in the fund management industry have also moved to "off-shore" locations such as Luxembourg and Ireland, arguably not just to benefit from fiscal advantages but also because of differences in regulation and supervision. But there seem to be few if any examples of financial institutions moving their headquarters

[9] Three committees for Securities (CESR), Banking (CEBS) and Insurance (CEIOPS) were established on the recommendation of the EU wise mans committee chaired by Baron Lamfalussy. The committees were recommended as a means to improve the quality and speed of transposing EU directives into national law.

[10] The FSAP was initiated in 1998 by the European Commission as a further set of policy initiatives to foster integration and provide a further stimulus to the development of the single market in financial services.

[11] See speech from Callum McCarthy, December 8 2004. He mentions accountability of regulators to national governments, differences in legal powers allocated to supervisors, differences in compensation schemes and levels of independence. Also, consider a large scale cross border acquisition (e.g. Deutsche/SocGen): the capacity for one or the other national regulator to lead oversight of the operations of the merged entity in their neighbouring country may well be questioned.

[12] See for example the policy statement issued in June 2005 by the European Financial Services Round Table entitled « On the Lead Supervisor Model and the Future of Financial Supervision in the EU »

abroad for regulatory purposes and then transferring previous home base activities into branch operations.

The extensive EU programme of legislative harmonisation, the FSAP, is an important counterpart to mutual recognition and the home/host structure. What started as an attempt to establish minimum common standards has more recently evolved into a programme of more extensive harmonisation. Much of the legislation coming out of the FSAP is now in a phase of interpretation and implementation at the national level. The aim has in part been to harmonise regulations across the EU in order to reduce the informal barriers to market entry and integration and thereby to stimulate competition. Compliance (both legal and otherwise) with different rules and market practices across the EU is often seen as costly and a significant barrier to integration[13]. Harmonisation is often seen as a way of providing greater scope for institutions to benefit from economies of scale when working across EU borders.

The Lamfalussy committees were established to provide technical advice on new legislation and to promote a common supervisory culture or practice among European supervisors. The committees only have an advisory role, with no legislative or enforcement powers. Yet with limited core staff, most of their work is performed by representatives of national supervisory authorities and hence there is a strong link to national supervisors with enforcement powers[14]. Supervisory convergence might also be able to reduce the costs of regulation by accelerating processes for passing new legislation.

National supervisors also coordinate among themselves at other levels, both bilaterally and in the framework of other European fora such as the Groupe de Contact (GdC) – which predates the Lamfalussy committees by some 30 years – and the Banking Supervisory Committee (BSC) of the European Central Bank. The GdC meets irregularly to discuss banking regulation and implementation issues as well as supervision. But it has neither standing surveillance nor legislative powers. The BSC provides an access for the ECB to maintain an overview of the financial system and another forum for discussion and coordination by

[13] Whether or not these costs represent significant barriers is open to debate. They may well be dwarfed by economic barriers to competition stemming from network effects or economies of scale.
[14] This link is seen as positive in that one might assume that joint proposals made by staff of various regulators are likely to represent a consensus that is in fact backed by a majority of supervisors. On the other hand, there seem to have been cases of regulators wearing a European hat involved in the process later on, wearing their national hat expressing doubts about the agreements reached in the European forum.

national supervisors. But it does not have powers of supervision nor a formal role to act in the event of a banking crisis.

Work on financial sector and supervisory integration has not stopped. But there is no consensus at the moment regarding whether some kind of European supervisory authority is really warranted, what scope or form it should take, and if so, based on which criteria. Nor is it clear when, if ever, the programme of regulatory harmonisation will be completed. In terms of supervision, officially, support is strongest for making the most out of existing initiatives (primarily the Lamfalussy committees) in the hope that they will achieve their mandate and that this will prove to provide a degree of convergence sufficient to assure efficient supervision and integration of the European financial sector. Nevertheless, instead of just dismissing prospects of further convergence, discussion of the practical problems that a European authority would face is increasing. This suggests that some at least are considering the possibility that the FSAP and Lamfalussy initiatives may in the long run be insufficient to achieve the policy objectives of European integration and preservation of market stability.

III. ARE CURRENT ARRANGEMENTS ADEQUATE?

This section briefly outlines three problems with current arrangements that fuel support for more ambitious initiatives. Proponents of further convergence of supervisory institutions – and perhaps even the ceding of national powers to a European body – often invoke three arguments. The most important and real issue concerns the core responsibility of regulators: (1) many, including supervisors themselves, concede that further convergence is necessary in order to improve prudential supervision and maintain stability. (2) Internationally active institutions still find that working with multiple supervisors and within multiple legal structures present unnecessary costs and barriers to entry. Although this is not enough on its own to warrant far reaching change, it may be symptomatic of more general challenges to increased efficiency and responsiveness. (3) Lastly, there is a political argument that Europe's supervisors need to gain a "critical mass" in order to better support the interests of Europe's financial institutions and markets in the global economy. This is by no means an exhaustive catalogue of critiques of current arrangements, nor is their substance evaluated, but it does provide an indication of current debate.

III.A. *Maintaining stability in a fragmented supervisory structure*

The current level of supervisory integration is perhaps insufficient to maintain stability, notably as deposit-taking institutions are increasingly operating across borders. National authorities in charge of internationally active financial institutions may naturally be more concerned with safeguarding their own financial system and fail to take account of cross-border externalities in the event of a bank failure[15]. And in the event that a crisis does arise, even with the best intentions, management issues may be hard to resolve with the existing structure of lead regulators.

Although one might argue that it is only a minority of banks that warrant more integrated European supervision, these banks may quickly come to represent a disproportionately large part of the financial sector; and it is important that governments provide the support and pressure needed to allow regulators to keep ahead of market developments. Unfortunately the comment often heard is a fatalistic one - that we will probably have to wait for a crisis – and pray God a small one – to occur before political inertia is overcome and progress is made on further integration.

Reports on financial crisis management commissioned by the Economic and Financial Committee (The Brouwer reports)[16] have contained some of the clearest calls for further coordination and development of procedures to improve crisis management[17]. In particular, the 2001 report recommended further development of Memoranda of Understanding (MOUs) to deal with crisis management issues and to concentrate on co-ordinating supervisory responsibilities for major financial institutions. But not much in the way of visible change has taken place since then.

Of course it is possible that in a quiet manner, supervisors are continuing to improve their relations and prepare for dealing with cross-border crises. This corresponds to one of the

[15] See the recent paper by Schoenmaker and Oosterloo for an empirical study and discussion of the extent of the cross-border externalities.
[16] Reports to the Economics and Financial Committee (ECOFIN) of the European Council of Ministers on Financial Crisis Management
[17] The second report issued in 2001 recommended improvements to supervisors' management information systems, removal of legal impediments to the exchange of information, clearer identification of lead regulators by financial institutions and more detailed can comprehensive MOUs pertaining to procedures for crisis management.

pillars described by the chairman of the UK FSA on which arrangements for supervising across borders are built: the "fraternity of central bankers and regulators"[18]. But even at the best of times, supervision and coordination across countries is bound to be difficult. And that which cannot be seen may not be credible. The influence of informal friendly clubs on private sector dominance of the financial markets has receded since London's "Big Bang". It is questionable whether this type of arrangement will survive much longer in the field of EU supervision. So for those that doubt, there is ample reason to support to the view that a unified system of supervision might stand a better chance of dealing with stability issues posed by cross-border institutions than the current system of national supervisors.

Various MOUs have been put in place between supervisors to deal with crisis situations. Bilateral MOUs exist between national supervisors to exchange information. And there is another MOU on high-level principles of co-operation in crisis management situations that sets out the logistics for dealing with crises involving cross border banks. But the credibility of these MOUs is weak, as national authorities may often have strong incentives to break their promises when a crisis arises[19]. For example, the costs and risks of providing support for the system are borne substantially at the national level. But the benefits of supporting an internationally active bank, a foreign subsidiary of which gets into trouble, may be reaped mostly by the host country. In particular this may be true for banks operating in central or northern Europe where there are already high levels of foreign bank ownership. The scope of the MOUs is also quite limited due to legal constraints on a national basis of the powers of supervisors and simple exchange of information may not be enough[20].

Arrangements for dealing with a failed bank, should the event occur, may also be considered underdeveloped. Numerous problems associated with the wind up and resolutions of such a bank have been identified. Differences in bankruptcy law, the rights of creditors and insolvency procedures may all result in conflicts. But supervisors are still accountable to their national governments and the public. The need for structures in which to manage these issues on a European level might also be cited as reasons for supporting further integration.

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[18] See Callum McCarthy's speech from September 22, 2004 on "How should international financial services companies be regulated?"
[19] see Mayes and Vesala, "on the problems of home country control" and comments by Oosterloo and Schoenmaker (2004)
[20] Erkki Sarsa (2005)

III.B. *The costs of doing business under multiple supervisors*

In particular for those institutions that do business across the EU (and more widely), greater unification of European supervision would reduce the uncertainties and costs of regulatory compliance. Instead of reporting to multiple regulators, banks would have just one interlocutor with final decision making powers. They also might anticipate a reduction in the level of local, i.e. national, law making that currently comes on top of EU directives and adds to the uncertainty of how new regulations evolve across the EU. Dealing with multiple regulators across European jurisdictions still imposes significant costs, both in terms of day-to-day business and in terms of the slow and cumbersome processes of legislation, especially where issues relate to the judgement of supervisors rather than just following the letter of the law.

Some of these costs may be reduced through current initiatives. Regarding transaction reporting or balance sheet reporting for example, there are efforts to agree upon and design EU systems which allow for standardisation and one point of entry for financial institutions. Supervisors would enhance their ability to exchange data in order to alleviate multiple reporting requirements and formats for authorised institutions.

But there are other issues that the Lamfalussy[21] process has not yet demonstrated it can resolve. For example, the CESR "level 2" work to provide technical advice to the legislative process should in principle help to speed coordinated responses to changing markets. But this has yet to be demonstrated[22]. Recent experience from MiFID[23] proposals being worked on by CESR has seen calls for the extension of deadlines. Although financial institutions have been involved in the consultation process from the start, some of the operational implications of regulatory changes have become clear only recently. This has required further discussion and may create further delays. Frequent changes also seem to have been made to the drafts currently being worked on by the Commission.

[21] The Lamfalussy responsibilities are framed in terms of "levels" in the legislative process. Level 1 corresponds to the adoption by the Commission of proposal for EU directives. At level 2, CESR and other Lamfalussy committees provide "technical advice" on the interpretation and implementation of directives and proposals are refined in coordination with other EU institutions. Level 3 focuses on improving the day to day transposition and implementation. And level 4 represents enforcement by the Commission, improving complete and consistent transposition at the national level.

[22] See the European Parliamentary Financial Services Forum Briefing on the Lamfalussy Process 2004

[23] MiFID stands for The Markets in Financial Instruments Directive

Even if the process improves and progress is made in the harmonisation of rules, interpretations and enforcement, the markets - and hence regulatory agendas – will keep moving. With primary decision-making powers still at the national level, there will never be full convergence under the current legal framework. The current pattern of events is for policy changes to first be made at the national level, and then discussed in the European context[24]. EU rules may constantly be trying to catch up with national changes. Within the current framework, uncertainty, administrative inefficiency and slow legislative processes will continue to act as a burden, especially on internationally active financial institutions.

An extension of this argument holds that, given the time value of money[25], the economic value of incremental convergence is low, even if it (i.e. convergence) is deemed to be successful according to the mandate. Future savings gained from gradual decreases (over a number of years) in barriers to entry and administrative costs are worth less than savings that can be made tomorrow from a more immediate removal of barriers today. Ultimately, a "big bang" approach to removing regulatory induced barriers to market integration may be most effective[26]. This may well entail more ambitious moves towards unified regulation and a unified supervisory structure.

III.C. *Does Europe need a unified supervisor to promote the interests of Europe's financial sector in the global economy?*

Not everybody believes this is even a relevant issue. But for many, the answer to this question is yes. This is of course a contentious argument, but nevertheless one that garners support in many political circles. Underlying it are motivations that feed support for creating an integrated European financial market. In network services that can benefit from economies of scale, size matters. The idea that European supervision needs to have a critical market mass

[24] Think for example of the current environment for alternative investment management, e.g. private equity or hedge funds.
[25] The long process of integration has also provided time for national consolidation to take place, hence raising further barriers to cross-border integration
[26] The timing factor may also have implications for the distribution of benefits from integration. Despite the FSAP, or perhaps also because of it, financial services activity has continued to concentrate itself in London. Arguably, the longer European institutional changes are delayed, the more the position of economies of scale will focus in London. Very small financial markets may benefit from this concentrated pool of resources if they can tap into it in London. For middle sized financial markets, delays may be less attractive, at least for actors employed locally in the financial sector. The longer it takes to establish a European structure of supervision, the less it may in the end contribute to preserving a geographical dispersion of financial sector activity.

behind it in order to be able to deal on even terms with supervisors in the US or other markets is intuitively plausible and, for many, politically attractive[27].

Arguably, a unified European regulator and supervisor would have more autonomy and decision taking powers than a loose collection of individual national supervisors in, for example, dealing with the US or Asian economies[28]. It is irrelevant whether one sees this as necessary in order to create a "counter-balance" to or simply an "equal partner" for the US. The point remains that for many, the current status of supervisory integration stops short of a unified European regulator and that this is one step too short.

IV. ALTERNATIVE ARRANGEMENTS: A DUAL SYSTEM OF EUROPEAN REGULATION AND SUPERVISION

Although there has been discussion of a two tier system of supervision in Europe, the implicit suggestion has often been that the pan-European option should be reserved for big international banks. For those on the wrong side of the cut-off mark, it might be described as a sort of *class system* separating the cosmopolitans from the locals, or even worse – a form of "regulatory apartheid". In contrast, there seems to have been little serious mention of providing financial institutions with a choice between national and European regulation and supervision[29]. Scope for institutions to choose between alternative arrangements represents a significant potential advantage of a dual system. Most importantly, a dual system would allow financial institutions to withdraw from their existing supervisor's authority and apply for authorisation by another authority while still operating in the same market(s).

This section first describes some essential features of a dual system that provides this scope for choice. It then presents some specific advantages of (1) a dual system in general and (2) a dual system with scope for choice. Of course there are numerous other design and policy challenges that a dual system would need to resolve that are not discussed here: deposit

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[27] The argument is particularly relevant perhaps in the context of debate on a "two speed" Europe. If Franco-German plans to forge ahead with a *noyau dur* succeed, regulation and supervision could mirror the arrangements for the Euro and central bank governance.

[28] In contrast, one could argue that current arrangements often allow multiple European representatives a greater say in international fora because they together outnumber those from bigger countries such as the US and Japan;

[29] One related proposal has been the so-called 26th regime advocated by EUROFI and still under discussion. This proposal entails allowing financial institutions to provide some specific retail savings, investment, or pension products in two "flavours" of regulation: European and national.

insurance, arrangements for emergency liquidity, government fiscal exposure, judicial enforcement of regulation, consumer protection and governance.

Most importantly, further discussion would also be required on the scope of activities to be covered by a European authority[30]. Although it goes against the recent trend of creating universal regulators[31], realistically, with the current separation of responsibilities between three[32] Lamfalussy committees, a series of regulators (European Securities Market Authority, European Banking Commission, European Insurance Supervisor, etc) might be the most likely outcome. Also, the geographical and business scope of an EFSA would indeed be staggeringly complex.

The absence of discussion of these issues from the scope of this paper is not meant to imply that they are somehow less important, rather that they merit detailed discussion in their own right or have been dealt with in other publications.

IV.A. *SOME ESSENTIAL FEATURES & ISSUES*

A dual system would break the "one state - one system" mould, which aligns regulations with national boundaries, as well as the "many states – one system" mould that would be entailed by complete harmonisation throughout the EU. It would allow financial institutions to subscribe to one of several alternative regulatory and supervisory frameworks: an EU one and a variety of national ones – any of which would provide them with full authorisation to conduct business across the EU and a framework in which to provide services to clients.

The key choices provided to financial institutions in a dual system would relate to the legal and regulatory framework in which they operate and the supervisory authority responsible for overseeing their business. Regulatory frameworks and supervisors would be a combined choice: one legal framework – one supervisor[33].

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[30] In the US for example, banking supervision has a complex dual structure, securities markets regulation is more centralised and insurance oversight is based on state arrangements. In the EU, the structure of three (perhaps soon to be four) Lamfalussy committees suggests that a non-integrated system of supervision and regulation might be preferred.

[31] Supervisory consolidation has in recent years been undertaken in the UK (creation of the FSA), Germany (creation of the Bafin) and France (creation of the AMF)

[32] perhaps soon to be four, with addition of financial reporting

[33] Supervisors could perhaps sub-contract some work to local supervisors

Legal and regulatory framework

A choice of legislation and regulation in a dual system implies that there would be a separate (i.e. from national) EU legal system for governing financial institutions and markets. Sometimes this has been referred to as an EU rulebook[34] and might be based on a comprehensive set direct legislation such as EU Council Regulations. This might overcome the heterogeneous legislation that can result from transposing Directives into national law. It could be achieved through gradual extension of Lamfalussy Committee powers. Or it may be decided that progress requires the creation, probably by Treaty amendment, of a separate authority with its own regulatory powers.

Most financial integration measures come in the form of EU Directives which need to be transposed into national law before becoming enforceable. But there are exceptions where Council Regulations are used, such as under discussion for MiFID or in the case of the Regulation on cross-border Euro zone transfers. Both Directives and Regulations face challenges of (in)consistency and legal uncertainty at the level of national laws. A uniform EU set of Regulations or rule book issued by a new authority would have to strive for legal consistency.

Nobody should underplay the significance of these problems. But neither should they constitute fundamental opposition to a directly applicable EU rulebook. The case for preferring Directives vs. Regulations is not clear either. For example, although supplementary comments[35] from International Swaps and Derivatives Association (ISMA) and others on MiFID indicate a clear preference for using Directives (in order to avoid legal disharmony), an earlier review of specific MiFID issues for them (ISDA) suggests that there are problems associated with the use of both Directives and Regulations, including those arising from coherence with existing national law[36]. Moreover, inconsistencies already exist on a national basis in most countries. And whereas the idea of an EU rulebook has generally implied supplanting national law, here the proposition is to provide an EU rulebook as a parallel alternative to national law. Scope would be created for market participants to weigh up the

[34] See for example comments by T. Padoa-Schioppa in the summary of the ECB-CFS symposium on Capital Markets and Financial Integration in Europe.
[35] See ISDA Supplementary Comments on Commission working document ESC/17/2005
[36] See ISDA "Implementing Measures under the Directive on Markets in Financial Instruments, Regulation vs. Directives" October 2004

relative legal risks in each system and allow lawmakers to learn from each others' experiences.

The design of a directly applicable set of EU financial sector legislation and regulation would nevertheless have to strive to ensure solid legal foundations and demarcate the boundaries of the EU legislation and regulation. The scope of such law would have to be negotiated among member states to prevent it from encroaching on or conflicting with fiscal, criminal or other issues in the domain of national law. Agreement would need to be reached for example on consumer protection in financial services and the extent to which laws and regulations dealing with this should remain solely the domain of national law[37] or be integrated into an EU framework. The judicial system for litigation and dispute resolution on EU laws and regulations of this kind would also need to be clearly defined.

Given the rise of international regulatory standards (e.g. Basel II, OECD corporate governance, IOSCO), the basic principles of national and EU laws and regulations might be very similar. But there would also be real scope for differences. This scope would be most limited at the level of laws but greater for actual regulations, guidelines and other more prescriptive codes[38]. Financial institutions would be in a position to analyse differences and decide which regulatory structure was most appropriate to their activities and business model. Allowing multiple regulatory structures to operate side-by-side might seem disturbing. But in many ways it would be an extension of existing efforts and arrangements to promote competition in activities still considered to be "natural monopolies", (e.g. stock exchanges, payment systems and audit).

Examples of differences in regulation might include some of the issues for which it is proving difficult to nail down a concrete interpretation, such as the treatment of internalisation and its relation to market transparency or the definition of "liquid securities". Differences could be warranted in the levels of perceived consumer protection: is a client to be treated paternalistically or is it a matter of "let the buyer beware"? Risk models and authorised external ratings could be treated and interpreted differently by different supervisors depending on the circumstances in their local markets.

[37] Independently, there may be some harmonisation of consumer protection legislation through the normal route of EU directives being transposed into national law.
[38] The system of state and federal regulation in the US also leaves real scope for differences. For examples see Ken Scott, Dual Banking

It should also be noted in this context that, even if the current Lamfalussy framework succeeds (according to its mandate), transposition into national laws and regulations may still fail to create a truly "level playing field". Of course CESR and others are charged with helping to ensure consistent application in spirit (rather than formalistically) across jurisdictions. But there are concerns that the differing legal structures and traditions across the EU will significantly hamper any attempt to ensure that the same EU rules translate into the same degree of significance in each national market[39]. The legal consistency problems cannot be easily solved or avoided whichever way one goes.

Supervisory arrangements

The other element of choice would relate to supervision of financial institutions and issuers seeking authorisation to operate, raise or manage funds, in the EU. Institutions could apply for authorisation (and hence supervision) by a national or an EU authority (perhaps an EFSA). This choice would however determine the set of laws and regulations under which the institution would operate. There would be what we might call a "one supervisor – one rulebook" relationship. Similarly, choice of disclosure and corporate governance regimes might be extended to include a distinct European framework.

Supervisory practices could also be open to significant differences. This would allow scope not only for "testing" different rules and tools of supervision. It could give supervisors scope for different approaches to assessing qualitative issues and to improve the coherence between the details of their rules and guidelines and the tools or methods used to help monitor compliance and enforce them.

A European supervisor could ensure consistent application of EU rules and regulation across all national markets for its mandates. This would be an attraction for many regulated institutions because it would enable them to spread the use of systems and operations more widely across EU operations with fewer local variations to accommodate and less risk of independent national rules being imposed on top.

National supervisors might benefit from greater flexibility to adapt or interpret regulations to best fit their local market circumstances with less pressure to comply formalistically with consensus based EU-wide interpretations. In the area of corporate disclosure, this could

[39] See for example the responses to the Green Paper on financial sector policy 2005-2010 by Europlace

perhaps help to overcome problems such as implementation of European wide accounting standards or other measures to guarantee transparency of collective investments. Local issuers could retain rights to comply with national rules while allowing those companies and funds seeking wider market acceptance to adopt EU standards if they wish.

Critically, Supervisors would also be able to set the level and structure of fees levied on regulated institutions. These would need to be open and transparent in order to facilitate sound decisions by financial institutions.

A variety of choice of regulatory and supervisory arrangements could be imagined. Choices could also extend beyond the simplified distinctions provided here between regulations and supervision. The US model provides a far wider scope for choice between regulation and supervision. Arguably the benefits of extension of such a wide scope of choices would be outweighed by complexity of the system[40].

Examples

With a combination of national and European supervision and regulation, at least three variations of supervisory models might exist:

- authorisation by the EU authority with operations across any number of European Member States
- authorisation by a national "lead regulator" with or without operations across other European countries
- authorisation by a foreign "lead regulator" (e.g. an Italian bank could decide to apply to switch from Italian to German supervision, without necessarily moving its headquarters there)

IV. B. *ADVANTAGES OF A DUAL SYSTEM OF SUPERVISORY ARRANGEMENTS*

There are several reasons why a dual system of regulation and supervision should be considered. This section first outlines some general advantages of a dual system. The

[40] As a comparison, the US model (just for banks) also offer choice, possibly too much as some US critics argue. Further details on the "tangled web" of regulation in the US are provided in the appendix. See also reports from 1996 and 2004 from the US Government Accountability Office

following section then outlines advantages that more specifically derive from the scope for choice under a dual system.

IV.B.1. A response to the one-size (does not) fit all dilemma

The European financial sector is still very fragmented. The majority of institutions still operate on a domestic or sometimes even sub-national basis. But many big institutions are increasingly operating on a European scale, across numerous countries. There are important differences in the size and structure of financial institutions across Europe. In some cases, the same products and services may on the one hand be offered by multinationals and on the other by independent financial advisors. There are also differences in legal structures (cooperatives, private banks, listed banks). A dual system would provide scope to adjust regulation and supervision to accommodate some of these differences, limiting some of the one size fits all problems.

Benefits for "European" and "International" Financial Institutions

For those few (but increasing number of) institutions that do operate across numerous jurisdictions in Europe, in particular in the wholesale markets and serving large corporates, some form of supervisory consolidation would probably be welcome – both for the institutions themselves and for the sake of maintaining stability. These institutions may quite rightly see the pace of integration in Europe being restrained by the "slowest" institutions. The creation of a dual system would allow those institutions most in need of supervisory consolidation to move ahead. But one of the hurdles on this path is lack of support from the sometimes less vocal majority (in numbers at least) of national and regional banks.

Benefits for "Local" Institutions

Domestic focused institutions could continue to work with national supervisors. This would save them from having to comply with a costly transition to a European system of supervision that may be seen as not only unnecessary but also disadvantageous for them. Smaller institutions in particular often feel that regulations are designed with big institutions in mind and are less adapted to their structures[41]. Regulators are conscious of this problem, but it is not always easy to resolve. Local banks cite disadvantages from standardisation of systems and risk assessment using hard data. Relationship lending often relies on "soft information" acquired over time that is difficult to standardise or process without loosing much of its

[41] Another case in point is the potential impact of IFRS on cooperative banks' balance sheets.

value[42]. Preserving flexibility through a system of both local and regional (i.e. European) supervisory structures might enable diverse business models (approaches to risk assessment for example) to be more easily accommodated side by side. And it would allow national regulators to specialise too. Clients could then make their own choice between European and national offers, letting the market drive integration.

Supervisors might also benefit in many ways from remaining “close” to the firms that they regulate and the markets in which they operate. For the vast majority of institutions, this means that there would be little obvious value, either for them or regulators, in a transfer of supervisory powers to a centralised European entity, with little experience and operating in a new and uncertain legal framework. Similarly from the point of view of maintaining stability, it is not clear what benefits would be derived from direct EU supervision of small local institutions, whose eventual failure would have little if any impact on other countries.

But there are concerns that a dual system will marginalise some banks

Somewhat surprisingly, a dual model is not clearly supported by “local banks”. The German Savings Bank group (DSGV) has suggested it would favour such a model by emphasising their concern that full harmonisation and standardisation in retail markets would be a mistake[43]. But there also seems to be a distinct fear that a dual system could evolve into “regulatory apartheid” and give way to a distinctly uneven playing field pitched in favour of international institutions. This concern has been expressed lately by the European Savings Bank Group (of which the DSGV is a member) in their comments on a recent Commission Green Paper[44]: “This could lead to a distortion of competition which is not in line with the principle of a single market”[45]. This view is surprising. Especially if banks are given a choice, one would expect that, if anything, in a dual system, national regulators and supervisors would create more favourable conditions for local banks under their supervision.

IV.B.2. *Experience from the US dual banking structure*

[42] See Bakker, Klapper and Udell: Financing Small and Medium-sized Enterprises with Factoring and the FDIC study on the future of community banks for references to the importance of hard vs. soft information and the capacity and will of different kinds of banks to process it.
[43] See the DSGV statement on “Europäischer Binnenmarkt für Finanzdienstleistungen: Vorrang für Wettbewerb und Vielfalt“ at www.dsgv.org
[44] See the ESBG response on the Commission’s Green Paper on Financial Services Policy 2005-2010
[45] Page 31 of the above mentioned comments on the Green Paper

Some insight into the possible consequences of a dual system for local banks can be drawn from the US where banks have a wide variety of choice in terms of regulation and supervision, not least between federal and state authorisation[46].

A study by the US Federal Deposit Insurance Corporation (FDIC) recently analysed the decline in numbers of community banks[47] and the challenges that they face[48]. Regarding regulation, they find support for the claim that the costs of regulation weigh more heavily on community banks. But they also emphasise that there continues to be scope – and a need – for community banks. Records show that during the period from 1985 to 2003, there were 2,275 "de novo" community banks established in the US [see footnote for comparable European figures][49]. More market space seems to have been opened up for outside competitors interested in targeting local markets or offering niche services outside the focus of the larger banks

Overall figures also suggest that the end of local banks is nowhere in sight. Although the total number of state banks has declined since 1990 (*see chart 1 below*), the decline in the number of federally chartered banks has been even greater[50]. In general there has been consolidation throughout the financial sector in the US during this period. In some years, in contrast to federally chartered banks, the number of state regulated banks has actually increased.

[46] As Ken Scott says in his paper on the dual banking system (page 3): "The mere choice between state and federal chartering cannot begin to suggest the true intricacy of the dual system. In commercial banking, for example, there are four possible patterns of regulation:.."]

[47] Defined as independent banks and savings institutions with total assets of less than $1billion

[48] See the FDIC "Future of Banking Study, Community Banks: Their Recent Past, Current Performance, and Future Prospects, 2004. The study sees "Community Banks" primarily as small institutions, with an asset base of less than $1 billion. Although the net number of such banks has decreased, a significant number of new community banks have been created since 1992. This contrasts with a very low number of "de novo" banks created in the EU.

[49] As a comparison, in France over the period 1995 to 2004, there were 34 new branches of EU banks created and 11 new banks established under direct control of the French supervisory authorities. During the period from 2001 to 2004, there were 105 successful applications made to the German regulatory authority for permission to conduct banking activities

[50] Much of this decline can be attributed to consolidation in the form of mergers.

chart 1: number of banks in the US by year and charter type[51]

US Financial Institutions - evolution by charter type and Federal Reserve membership since 1990											
report date end year	all FDIC	commercial banks	**national banks**	**% change**	**state-non member**	**% change**	**state-member**	**% change**	savings institutions	federal thrift institutions	state thrift institutions
1990	15158	12343	3979		7355		1009		2815	1518	1297
1991	14482	11921	3790	-5%	7157	-3%	974	-3%	2561	1389	1172
1992	13852	11462	3593	-5%	6914	-3%	955	-2%	2390	1305	1085
1993	13220	10958	3304	-8%	6685	-3%	969	1%	2262	1256	1006
1994	12603	10451	3075	-7%	6400	-4%	976	1%	2152	1203	949
1995	11970	9940	2858	-7%	6040	-6%	1042	7%	2030	1170	860
1996	11453	9527	2726	-5%	5785	-4%	1016	-2%	1926	1096	830
1997	10923	9143	2598	-5%	5552	-4%	993	-2%	1780	1008	772
1998	10464	8774	2457	-5%	5323	-4%	994	0%	1690	955	735
1999	10222	8580	2365	-4%	5205	-2%	1010	2%	1642	931	711
2000	9904	8315	2230	-6%	5095	-2%	990	-2%	1589	915	674
2001	9614	8080	2138	-4%	4972	-2%	970	-2%	1534	883	651
2002	9354	7888	2077	-3%	4861	-2%	950	-2%	1466	846	620
2003	9181	7770	1999	-4%	4836	-1%	935	-2%	1411	815	596
2004	8975	7630	1906	-5%	4805	-1%	919	-2%	1345	781	564

"membership" refers to status with regard to the Federal Reserve System

Source: FDIC bank data

IV.B.3. ***A better alignment between sponsors and beneficiaries of the safety net***

In order to safeguard the stability of the financial system and protect small investors, national governments (and their taxpayers) may incur considerable costs to support a failed institution or simply provide implicit guarantees from which financial institutions benefit. But the structure of international expansion is not symmetric, i.e. some countries are exporting more (in GATS mode 3 terms especially) than others. Hence there are some supervisors who, under a lead regulator model, would be net exporters of "stability services" and others that are would be net importers. But for the time being these are externalities that are not explicitly priced[52]. This can be a problem as quite often, "you get what you pay for". Although still limited, research shows that the magnitude of these externalities is growing[53].

There are some potentially positive externalities: US, French and Austrian banks may implicitly be subsidising their home banks' activities and their clients in Central and Eastern Europe by providing a safety net. In so far as this represents a transfer from rich countries to poorer ones, perhaps this is a good thing. But this is not a serious agreement within Europe and there is substantial uncertainty surrounding any commitment by a foreign government to bail out foreign subsidiaries.

[51] For further explanation of US bank charter structures, refer to the appendix A
[52] This can be seen as a positive externality of supervision by foreign authorities – i.e. to some extent, host countries benefit from the export of better risk management and supervision practices maintained abroad.
[53] See Schoenmaker and Oosterloo (2004)

Who should take responsibility for financial institutions operating internationally? Under current arrangements emphasis is placed on agreements between the lead supervisor and supervisors in countries hosting subsidiaries and branches. But in the event of a crisis requiring financial support, the lead supervisor – and its government finance ministry - may be less concerned with the interests of depositors (or policy holders) at small foreign subsidiaries than the host finance ministers and supervisors. This may be a particularly important concern in countries in eastern Europe or the Nordic region where a number of foreign owned banks have significant market shares. Everyone has a clear interest in supporting the system (in the case of banking problems), which may involve preventing the failure of one subsidiary from leading to the failure of another and sorting out conflicting claims of creditors. But as emergency financial support to cover losses remains the responsibility of national governments the value of existing agreements is unclear as regards cross-border problems.

A natural response to the problem of national bias has been the idea for a European authority with an EU-wide mandate to take charge. But under a hypothetical *single* EU supervisor, the lack of an EU fiscal institution would make the financial aspects of the problem even more pronounced since it would be ambiguous where financial responsibility lay. Direct support from national governments, in the form of either guarantees or a fund, would be one way to address this. But, by providing funding commitments in advance, governments would risk making fiscal transfers to cover losses at institutions active in only one or a small number of countries. An alternative would be to create an insurance fund paid for by supervised financial institutions, appropriately priced for risk. But to be fully credible governments would have to stand clearly behind the fund.

In contrast, a dual system of European supervision would minimise this problem by requiring such commitments from member states only to cover EU supervised institutions. Those institutions having chosen to be authorised on an EU level will be much more likely to operate in many countries. On the other hand, institutions with few cross-border activities would probably choose national supervision and only national authorities would face financial commitments. Hence any eventual costs to member governments in an eventual rescue of such institutions are likely to be more evenly offset by benefits to their own depositors (or policy holders).

IV.C. *THE MERITS OF PROVIDING CHOICE IN A DUAL SYSTEM*

Perhaps more important than the above arguments is the extent to which a dual system would be able to provide a choice of regulatory and supervisory arrangements to financial institutions. The fact that so much time, effort and debate have been dedicated to designing and constructing regulations in Europe attests not just to the interests at stake but also to the lack of definitive answers to many questions on what works best. The trouble is that, we just do not know what works best; and what works best may depend significantly on the business models of regulated institutions, their clients and the evolution of the markets. The future of European financial markets relies on a delicate balance between harmonisation and the ability to preserve competition, test new options and allow market participants the freedom to innovate, to find out what works best for them – and the economy; in short to allow the financial markets to evolve. The following section outlines some of the specific advantages of a dual system with choice.

IV.C.1. Benefits from regulatory innovation and competition

Harmonisation of regulation could in theory give a boost to markets if it were possible to be sure of choosing the "*right standards*". But even if we were to assume that we could find the "right standards" that fit for all countries and institutions[54] and foster efficient markets today, these same standards may prove to be less efficient tomorrow if technology, business models and economic conditions change. Institutional structures for supervision and regulation should incorporate incentives to adapt to such changes when they arise. But a single European supervisor that supplants national authorities – as with monopolies in the private sector – may have weaker incentives to adapt and reform regulations quickly. A dual system may help to establish a regulatory environment that is more responsive to innovation by financial services providers due to the scope for competition between national and EU authorities, and the scope to test new regulatory solutions.

Critics of a single European supervisor note for example that "one disadvantage of a single European authority is that it would set an end to inter-agency competition. This competition, however, is beneficial since it fosters efficiency and innovation"[55]. This is indeed an important reservation of a truly single supervisor. A dual system of supervision with choice

[54] Hence overcoming the issue that one size may not fit all
[55] See Heinemann 2002, (page 58)

would not only maintain scope for inter-agency competition but might divert its focus from competition between national authorities to competition that cuts across national sympathies by focusing on differences between national and pan-European regulations.

A dual system can also preserve scope for diversity and experiments in regulation. Often it is not clear what the best approach is to regulating a new product or service. The current diversity of approaches by national authorities could be preserved in a dual system, yet enable them to coexist and compete in the same markets with alternative supervisory solutions. This scope for experimentation may be very valuable to both supervisors and market participants[56].

Should we be afraid of a race to the bottom?

Of course there are some participants in the debate likely to be concerned that such open endorsement of regulatory competition will incite a “race to the bottom”. There is no clear-cut answer to this issue, but there is evidence that should serve to relieve these concerns. Where financial institutions and companies have had the opportunity to vote with their feet, they have tended to set up operations or list in more highly – more professionally – regulated jurisdictions[57]. There is indeed a high degree of correlation between the stability, depth and integrity of financial markets and the quality of their regulation. Companies do no strive to list in un- or badly regulated markets but in those that help to reinforce investor confidence. Banks too must ensure that clients are not scared off by a reputation of the jurisdiction for bad risk management and lax supervision. In fact, the more depositors can have access to foreign retail services (for their domestic needs) the more a flight to quality may become evident.

Evidence from recent European history also suggests that real interest in exploiting potential for regulatory competition is low anyhow. The Single Market Act in principle provides some scope for regulatory competition, enabling banks and other institutions to establish branches in other EU countries under the supervision of their home regulator. In 1995, a total of 179 bank branches had been opened (or converted from existing subsidiaries) in other European countries (see Single Market Review). This compares to a total of well over 10,000 institutions across the EU in 1994 and an estimate of 131 mergers and acquisitions between European banks in the period 1985 – 1995. Although barriers certainly remain, and did so at

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[56] There are comparisons here with the 26th regime proposal, which advocates the creation of parallel product standards and legal frameworks for specified retail market products

[57] See for example the paper by John Coffee : Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance

the time of these statistics, there has clearly been no rush to exploit regulatory competition and give way to a race to the bottom.

Instead of any tendency to unduly relax standards to attract further mandates, a study by Richard Rosen[58], supports an alternative hypothesis: regulators seek a "quiet life". When managers of a bank want to undertake changes to its business model that have an impact on their risk structure, the regulator is obliged to inspect, analyse and take decisions which could be criticised later if the bank gets into trouble. If regulators seek the "quiet life", they may discourage change, putting barriers in the way for banks to innovate or adapt to changing markets. Supporting this hypothesis, Rosen finds evidence that banks are more likely to switch regulators in the US (where choice of supervisory arrangements does exist) when they undertake an important change in their business or portfolio strategy.

These findings also have important implications for EU integration policy and scope for a dual system. One of the biggest barriers to EU financial sector integration is simply the status quo. Big institutions have established market shares and benefit from their status as dominant incumbents. This limits the opportunities for new entrants that might drive European integration. One of the best chances for competitors to surmount the advantages of incumbents and attract their clients is to exploit new business models and services. Innovation is an important force in the transformation of market structures and integration. But if changes to business models are effectively discouraged by regulators seeking the quiet life, the EU may be retarding market integration. Allowing financial institutions a choice of supervisory arrangements would diminish this risk of regulatory inertia stifling innovations that may contribute to the single market.

IV.C.2. *Potential to shift the fault lines of competition from the national arena towards competition between European vs. local institutions*

Choice of supervisor and regulatory framework can also provide scope for individual financial institutions to optimise their business model. As suggested by applications of the theory of the firm to financial institutions, supervision can also be considered as a factor influencing future earnings. As Ken Scott outlines in his defence of the US dual banking system[59], if financial institutions seek to maximise profits and are faced with a choice of

58 See Rosen 2001
59 See Ken Scott: The Dual Banking System : A model of regulatory competition

different supervisory structures, they will choose the most efficient model for them taking account of the investment necessary for conversion.

An efficient outcome for the financial system would allow for a natural selection process to operate and itself establish equilibrium between different regulatory options. "Each bank evaluates the advantages and disadvantages of each option in terms of its own location, type of business and set of competitors"[60]. With the option to withdraw from one supervisor and apply for authorisation by another, financial institutions maintain scope to react to changes in their business model, strategy and the economic environment.

A consequence of allowing financial institutions to choose between alternative regulatory arrangements to best suit their business models is that the differences between such models may be accentuated and become more obvious. This could increase the European dimension of competition between financial institutions by increasing the importance of the choice made by banks to operate as local or European institutions. This might signal a decline in the relative significance attributed to a financial institution's national origins. In so far as demand factors play a role in stimulating the emergence of "European" banks, the signalling potential vis-à-vis clients of choosing to be regulated nationally vs. on an EU level should not be underestimated.

With total regulatory and supervisory harmonisation throughout Europe, scope for diversity in business models in the financial sector might be constrained. Although regulation is only one component influencing such strategy decisions, it is a significant one. In a dual system, supervisors may find an interest in "specialising" their practices and regulations at the margins to more efficiently accommodate certain business models. A European regulator may for example gather more experience in the wholesale markets and with international banks offering high end retail services. They may invest more into ensuring that their approach facilitates the efficient and stable development of these institutions and markets. A national (local) supervisor may in contrast have responsibility for many local savings banks and also seek to interpret and apply regulations in a manner conducive to the development and stability of these types of institutions[61]. Supervisory specialisation could increase the importance of choice of regulatory structure for authorised institutions.

[60] Ibid page13
[61] An example could be drawn from discussion of Basel II requirements which increase pressure on banks to base credit decisions on "hard data"; but soft data can also be of importance, particularly to small savings

Will we then have a level playing field?

This structure could raise criticism from those that call for a “level playing field”. But we must recall firstly that one of the most important motivations for a level playing field in Europe is to erode differences between **national** supervisory models that hinder trade. Different business models should be given the chance to compete with each other on a level playing field, but there is no assurance that the current field is actually level! Secondly, it is important to remind ourselves that forcing everyone to play by the same rules, on the same field, requires some confidence in the superiority of the rules chosen. But unfortunately we do not have grounds for establishing the absolute superiority of certain rules over other ones. We are plagued by uncertainty. Hence there is sound justification for allowing different sets of rules to compete. What policy should seek to ensure however is that it favours competition on the basis of efficiency of different business models and not simply between governments’ capacity to support national champions.

IV.C.3. <u>*A safeguard against abuse*</u>

Another specific advantage of supervisory choice in this context is the safeguard it provides to financial institutions against abuse of regulatory powers or resistance by regulators to approve new business practices. Richard Rosen, in the already cited study on regulatory competition[62], suggests that if banks are trying to implement value-adding changes to their business but face resistance from their supervisors, they can change regulators and get a “second opinion”. Similarly, Ken Scott cites a study by the American Bankers Association that saw

> “the historic value of the dual banking lies in its ability to provide an escape valve from arbitrary or discriminatory chartering and regulatory policies at either the state or Federal level…One of the historic objectives of dual banking has been to provide alternative supervisory frameworks under which commercial banks may choose to operate”[63].

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banks that engage substantially in relationship lending. A national supervisor with many local banks under its authority might take steps to accommodate concerns that standardised risk assessment methods may be inefficient at capturing important information contained in soft data.

[62] Richard Rosen 2001

[63] Ken Scott page 12

Of course in the current climate in Europe, support for independent and non-discriminatory regulators may be strong enough to allay fears of abuse. But the risk cannot be excluded, particularly at the national level. Providing alternatives to financial institutions can not only foster peaceful resolution but also create incentives that naturally curb the emergence of abuse.

IV.C.4. *Regulatory Competition will put political prejudices to the test*

A final advantage of choice relates to the political process of moving forward the agenda on supervision. Many of those against further convergence seem to fear that a European supervisory authority will be overly protectionist and interventionist and would risk stifling innovation in the financial sector. In particular this seems to be a concern held by many in the City of London, the de facto financial centre of Europe (and the leading international centre too). Such sceptics consider the success of London as an international financial centre as being at least partly due to the skilful supervision of the UK's FSA[64]. Surveys on institutions' views of the FSA and its development support this view[65]. The financial centre of London is also important as a motor of growth and jobs not just for the UK but also for Europe as a whole. A European supervisor could put all this at risk if indeed it adopted an excessively interventionist stance or pushed international business offshore through attempts to protect EU markets from foreign competition. Of course this is a prejudice which is difficult to defend. Nevertheless it is a justified and important concern. A dual system could help to circumvent this barrier to political progress.

With the preservation of choice (and national regulators), financial institutions could choose to remain authorised and supervised by the UK FSA if they deemed this more favourable. And later on, if an EU bank found an EU regulator too interventionist, it could still change its mind and be free to apply for UK authorisation. Fear of this happening would also provide incentives to a European supervisor to dispel prejudices. Hence a dual system could garner support from those that seek to establish a European supervisor while also providing an assurance to sceptics in the UK and elsewhere that, were an EFSA really to become too interventionist, the City of London and its position in world markets would not be put at risk.

[64] See Ruben Lee, 2005

[65] A British Bankers' Association member survey from 2003 indicated on the whole a positive attitude towards changes at the FSA. And although most respondents thought the FSA had made no significant difference the UK's attractiveness as a financial centre, those noting any change overwhelmingly saw it as positive

V. SUMMARY

This paper has provided a sketch of what a dual regulatory and supervisory system in Europe would imply and what its merits would be compared to both the status quo and a single supervisory structure that supplants the role of existing national authorities.

Support for further supervisory integration in the European Union seems to be growing. Any new framework must try not only to reconcile potentially incongruous objectives but should also strive to create a more dynamic environment for European financial services providers. And as speed of reform is also important, solutions must be found that stimulate political support from a wide scope of financial institutions, thereby avoiding long and drawn out negotiations through opposing lobby interests. A dual system of supervision of regulation has its merits. But to exploit its greatest potential, all financial institutions should be provided with a choice under a dual system between European and national regulators. A dual system with choice may be able to leverage regulatory competition to allow the market to work more flexibly and foster integration while minimising the risks of stifling innovation and disfavouring local institutions through imposition of excessive harmonisation and a "one size fits all" policy.

Supervisors are currently drawing attention to the practical difficulties that an EFSA would face, almost to the extent that one might believe progress to be impossible. But we should take these as problems to which solutions must be found rather than barriers to progress. Here too, misuse of the "precautionary principle" does European integration a disservice. Even quite a large collection of difficulties and challenges does not in itself constitute a fundamental argument against further convergence. If anything, it stands as an argument for dedicating more resources, thought and reflection to the task of finding solutions. The best proof that such hurdles can be overcome is the European Central Bank, which arguably faced more challenges to its creation than would a European FSA.

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APPENDIX A

AN OVERVIEW OF "THE TANGLES WEB OF BANKING REGULATION" IN THE US

The US system of banking regulation and the diversity it provides goes well beyond the choice between federal and state charters. It has a primary level of regulation, that of the "chartering authority", and a secondary level of federal origin that covers a wide variety of rules such as reserve requirements and deposit insurance. There are also a variety of choices at the State level.

Financial institutions can choose to be chartered as commercial banks, thrift institutions or credit unions at the state or federal level. At the state level they can also be chartered as industrial loan companies.

The main authorities concerned with the regulation and supervision of banks in the US, simply at the federal level, are:

- The Treasury
- Office of the Comptroller of the Currency (OCC)
- The Office of Thrift Supervision (OTS)
- Federal Reserve
- Federal Deposit Insurance Corporation (FDIC)

All banks are regulated at the federal level if they are members of the FDIC. Banks can choose not to be members of the FDIC. Federally chartered commercial banks are overseen by the OCC. Federally chartered Thrift institutions are supervised by the OTS. Members of the Federal Reserve System are subject to oversight by the Federal Reserve.

The main categories of banks according to their regulatory status are:

- National banks
- State member banks (i.e. member of the Federal Reserve)
- Insured non-member banks
- Non-insured banks

The range of variables that are subject to banks' choice of regulation and supervision include:

- chartering authority
- sponsor for admission to the Federal Reserve membership
- sponsors for admission to the Federal Deposit Insurance Corporation (FDIC)
- Examining authority(ies)
- Authority requiring reserves
- Regulations
- Authority with right to assess mergers and acquisitions
- Controller of bank holding company