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Working Paper
April 14, 2008

European Financial Supervision in an Age of Growing Financial Integration: The Current Situation and the Outlook for Reform

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Summary

This paper will first discuss how the current configuration EU financial market and supervision evolved in its historical setting. The paper will then identify some of the difficulties posed for supervision that arise in the present situation and the proposals that have been made to resolve these difficulties. Subsequently, the practical problems that must be addressed in building consensus for reform of financial supervision and the attitudes of key participants will be analyzed. Finally, some practical suggestions will be made about the best way to move forward to arrangements for supervision that are suitable for the expected higher level of integration in Europe.

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Introduction and Overview

In recent years a sustained and lively debate has been under way concerning the appropriate arrangements for the supervision of financial groups that are active throughout Europe. The reality underlying this debate is that an increasingly integrated financial market is emerging in which many institutions operate as pan-European entities while supervision of financial activity is still exercised on a national level. Consequently, supervisory authority is often fragmented, with many overlapping mandates and duplication as well as ambiguities concerning final responsibility in times of crisis. Many analysts have proposed to remedy these defects through the creation of a new EU supervisory body or the designation of a "lead supervisor" with enhanced powers to exercise oversight of pan-European financial groups.

The incongruity between national supervision and international markets is not unique to Europe. It is a basic trait of the international financial system, in which intermediation increasingly takes place in a market-driven environment that transcends national frontiers while the legal and regulatory framework for finance remains predominantly national. Therefore, many of the issues raised in an EU context in this paper and elsewhere can also be raised with respect to institutions operating internationally outside of Europe.

At the same time, there are some reasons why these issues are especially important in Europe. First, the market reality is that a significant integration of financial markets has already occurred in Europe, which probably represents a more integrated market than any other region in the world. A number of financial institutions now conduct the preponderance of their business and manage their risks on a European, rather than on a

national or global, scale, even if they are still located in a particular European state and are subject to the jurisdiction of a particular national supervisor.

Second, cross-border activity in Europe is taking place in a context in which EU governments and the EU as an institution have an explicit long standing policy of supporting the construction of a single market in financial services. Over a period spanning decades, a number of policy initiatives have been introduced to further that policy goal. Elsewhere in the world, cross-border activity is also accelerating as market forces, along with a retreat of protectionist sentiment, have generally favored the internationalization of finance. In Europe, however, the fact that the EU and its member countries have this long standing commitment constitutes implies an obligation to assure that institutions operating in the integrated market are adequately supervised. Thus far, the EU has pursued the goal of financial integration while working within the existing reality of national financial supervision. Given expected further progress toward market integration, it is now apposite to ask whether the architecture of financial supervision needs to be reconsidered

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1. Historical Background: European Financial Modernization and Integration

It is generally acknowledged that financial activity should only be permitted to take place inside a defined legal and regulatory framework. Laws and regulations can only be issued by a public institution having the legal authority to issue rules in a given

jurisdiction. The authority to make such laws and regulations essentially lies with national governments[1].

Most countries consider it a matter of great importance to maintain democratic accountability for their legal and regulatory framework for finance. A soundly functioning financial system is directly related to issues of great social importance such as the protection of savings, prevention of crises and the maintenance of standards of market conduct. Lapses in financial policy can lead to problems such as losses of savings or financial crises and may require significant expenditure of public funds. Financial supervision may also entail the application of sanctions when rules are violated.

Those in charge of creating legal and regulatory systems must have means to be sure that those exercising supervisory authority are performing their takes adequately and in accord with society's values. Therefore, it is agreed that, even if certain financial officials such as central bankers and financial supervisors need to be allotted some operational independence, the most desirable situation is when supervisory officials are ultimately accountable for their actions to some elected body. Those making laws and regulations typically have a mandate to act in the interests of the citizens who elect those bodies and, thus, will want financial officials to act in their interest as well. Thus, any proposal to transfer supervisory authority away from national authorities where they can be held accountable will be scrutinized to determine whether the broader objectives of financial supervision will be achieved on a supranational level.

It is instructive to review the process by which the present European financial system arrived at its current state of financial development and integration. Before the current period of financial modernization, say 25-30 years ago, European countries had widely differing levels of financial development, but in general finance was much more regulated and bank dominated than it is today. Capital markets lacked dynamism and liquidity and government interference was pervasive. Each country had its own interpretation of the most desirable legal and supervisory framework for finance.

[1] In cases, some of that supervisory authority may be exercised on a sub-national level. Cases in point are insurance in the United States, securities in Canada and some aspects of investment in Germany.

Reflecting different historical experience and cultural values, views varied considerably concerning the optimal degree of competition and liberalization, but, on average, most countries tended to restrict the operations of markets to a very high degree. Financial institutions, especially banks, were under heavy control by government and were expected to fulfill a variety of economic and social goals. Controls on interest rates and credit allocation guidelines were common. In many countries there existed a range of institutions such as savings banks, publicly owned banks and credit cooperatives that operated under special statutes. These institutions were not expected to produce returns to shareholders and operated under a separate set of rules where market discipline was often not strong.

Each country had its own definitions of banking, investment, insurance and other financial activities, and domestic laws and regulations spelled out in fine detail the functions that each category of institution was permitted to fulfill. The capability to develop new financial products or to compete by price was limited. Many countries had institutional and regulatory frameworks that made it difficult for modern securities firms to function. For example, many countries required institutional separation between the process of order collection for securities trading and actual trading on markets, while anti-competitive practices on traditional stock exchanges were tolerated. Also, restrictions in many countries prevented securities dealers from making markets or from raising enough capital to take large net positions.

Many European countries, for example, Germany, had “universal banking” systems under which banks were permitted to engage in all financial services, and banks tended to dominate all phases of financial intermediation. Other EU countries, such as the United Kingdom, recognized investment as a distinct activity and thus had more clearly differentiated channels for bank and capital market intermediation. Countries that separated banking and securities tended to have stronger “investment cultures” with deeper institutional investor communities and a wider range of financial assets available to the public, while holdings of securities, such as bonds and equities, accounted for comparatively large shares of national income.

Attitudes differed significantly toward the degree of risk taking that should be allowed in intermediation and towards the desirability of liberalization, innovation and capital

mobility. Some countries simply forbade futures and options and many types of securities. In addition to being generally restrictive, supervisory doctrines and practices also differed significantly among countries, while consumer protection legislation resulted in additional differences among markets.

International operations tended to be of limited consequence. Many countries had explicit rules forbidding foreign establishment in their markets as well as policies of limiting the activities of foreign institution that were permitted to establish. Some EU members also had exchange controls that materially limited cross-border operations. Finally, many countries accepted cartels and other informal private arrangements that further lessened the scope for market access.

The “broad brush” characterization of European financial systems presented above, while generally accurate, has to be qualified to some degree. For instance, the Netherlands had a variant of the universal banking model, but institutional savings in that country were high and the equity market was well developed. France maintained capital controls until the early 1990s, but was reasonably amenable to financial innovation. While Germany had universal banking and discouraged financial innovation, it always had free movement of capital and accepted foreign establishment in its domestic markets.

The past 25-30 years have witnessed a remarkable rise in sophistication of European financial systems, which has gone hand in hand with the development of a unified financial market. In this process of modernization, the differences among institutional structures have narrowed considerably. The multi-purpose financial company, which combines banking and investment (and frequently insurance), has become the dominant institutional method for the delivery of financial services. Financial intermediation has been transformed from indirect intermediation on bank balance sheets to one where a much higher share of intermediation takes place directly through the capital markets.

The transformation of financial systems over the past quarter century has been driven by an interplay of market forces and changes in the legal and supervisory framework. In this context, five underlying forces can be identified 1) innovation by private markets 2) deregulation, liberalization and structural reforms by national governments 3) cross

border competition 4) the development of global norms and standards, and 5) actions to promote the development of a European financial market.

Throughout much of the past three decades European countries have been easing domestic controls and lifting restrictions on international operations. The motivations for deregulation and liberalization were complex. In many sectors as well as finance, public opinion has favored regulatory reform and is more willing to accept market-based outcomes than in the past. At times, existing controls and institutional segmentation may have been perceived as unable to achieve their stated objectives, as generating distortions and of becoming difficult to enforce.

Once controls are lifted private market participants can design new products and services based upon what final users demand without reference to national laws or regulations. Once this process is set in motion, existing legal and regulatory frameworks are likely to be tested. Even when the pressure for change in laws and regulations originates in the private market (as when a new financial product or instrument is proposed) or in an international forum (as when a new rule or standard is formulated), the change must usually be validated by a national supervisory body. Legislators, who had enacted the country's laws and created the supervisory regime, must be persuaded to authorize changes to remain in step with market practice.

One of the forces spurring modernization has been cross-border competition, which has encouraged deregulation and liberalization in order to maintain the competitive position of domestic marketplaces and domestic intermediaries. Institutions operating in international financial centers, such as London, tended to operate with relatively light regulation, in which the supervisor sought to provide the degree of protection that investors believed necessary rather than insisting on conformity with an existing legal and institutional regime. Since activities in international financial centers initially involved wholesale markets, issues involving the protection of smaller investors did not interfere with decisions to authorize new techniques. Flexible market-based regulation tends to permit financial innovations if there are no compelling prudential reasons to deny authorization. The Eurodollar and Eurobond markets centered in London, which had been given their initial impetus by regulatory rigidity in the United States, essentially

operated on rules that reflected the wishes of private intermediaries to offer new services and the demand for such services by clients and investors.

Alongside competition among private financial institutions, a parallel process of regulatory competition has been shaping the environment. Competition from institutions based in international financial centers encouraged modernization throughout Europe. It was common for institutions headquartered in European countries with comparatively restrictive institutional and regulatory frameworks to conduct operations that would not be permitted at home from London in order to operate in a more congenial environment than they found at home. Similarly, the major corporations turned to offshore centers for capital market funding, even if they continued to deal with banks on more traditional terms in their home markets. The possibility of migration to offshore centers obliged national authorities to consider seriously whether regulations served a genuine prudential need and whether activities were being driven offshore needlessly.

The chain of events that led to the emergence of modernized capital markets in Europe is revealing as to how the progression toward modernization unfolded. In the mid-1980s, the United Kingdom decided to overhaul its institutional and supervisory structures for financial markets for a number of domestic and international reasons (including strengthening its competitive position in financial services), The increasingly competitive conditions and rising cross-border competition for securities business that followed this move spurred other European countries to modernize systems for conducting securities business. Reforms usually included the authorization of new products such as futures and options and money market instruments. Basic overhauls of institutional and regulatory structures in the capital market were part of the reforms. Changes in legislation also contributed to the removal of restrictions on all financial institutions, which permitted banking securities and other financial services to be offered by the same entity and for enhanced competition among products originating in each sub-sector.

While laws and prudential regulations regarding financial markets continued to be set domestically, a growing body of international standards and norms began to develop. To some degree the development of international standards reflected the fact that finance was becoming increasingly international and in the absence of international standards

private financial institutions might seek to move operations to the jurisdiction that provided the desired regulatory treatment. Thus, since the 1980s the Basle Committee on Banking Supervision has been elaborating rules delineating the respective roles of home country and host country banking supervisors as well as rules defining capital and setting minimum capital requirements. In particular, the Basle Committee, under the 1982 Concordat, established the principle that the primary supervisory responsibility for bank branches lay with the banking supervisor in the home country of the bank, while for subsidiaries the host country has a recognized role in supervising the entity. Supervisors in individual countries were expected to align their domestic practices with the principles enunciated by the Basle Committee. Comparable efforts were undertaken by IOSCO for securities markets and the IAIS for insurance supervision.

The major developments mentioned thus far such as deregulation, liberalization and innovation, as well as the formulation of international norms and standards of financial supervision, affected all countries. Indeed, this period was one of rapid structural change, and internationalization in the financial systems of all OECD countries.

An additional factor was present in EU countries. The governments of EU countries as well as the European Commission (EC) have over most of this period maintained the priority of building a single unified EU financial market. The objective of developing a single market goes beyond that of simply removing explicit barriers to market access by foreign suppliers of financial services, as required by other liberalization agreements such as the OECD Codes of Liberalization and the WTO agreement.

The concept of the single market meant that any financial institution should be able to offer financial services throughout the EU through an established presence or through cross-border operations without regard to the nationality of the institution offering such services. In addition to removing explicit barriers to the provision of financial services, a higher degree of convergence of domestic legal and prudential systems as well as consumer protection laws was necessary.

The tension between the national control over the legal and supervisory framework for finance and laws and the goal of a unified market posed a challenge for the EU. European countries had significant differences in definitions of banking, securities and

insurance as well as prudential rules governing these activities, which if allowed to persist, might have stalled efforts toward integration indefinitely. One conceivable solution would have been to have a single set of laws and regulations for the EU with a single supervisor. Realistically, however, it would not have been feasible, either politically or conceptually, to have effected this change at once, particularly given the divergences of views about the desirable form of the financial system.

There is a strong presumption that the principle of 'subsidiarity' ought to be respected in the operations of the EU. This principle states that matters should be handled by the lowest competent authority, with the central authority only having a subsidiary function, i.e. performing only those tasks which cannot be performed effectively at a more immediate or local level. Subsidiarity is now a fundamental principle of European Union law. According to this principle, the EU may only act (i.e. make laws) where member states agree that action of individual countries is insufficient. This principle, which was already used in the EU since the 1980s, was formalized in the 1992 Treaty of Maastricht.

The path to the single market that was taken by the EC was to accept national differences while introducing the principles of 1) minimum standards, 2) home country control, and 3) mutual recognition. These principles were elaborated in Commission White Paper of 1985. (Commission of the European Communities, 1985.) Through various laws and directives the EC established minimum standards that were to be accepted throughout the EU. These standards were to be compatible with those set on a broader level by international groups responsible for setting global supervisory standards (Basle Committee, IOSCO and IAIS), but were to be more specifically adapted to the European context. In keeping with the principles of the single market, once a financial technique or instrument was authorized in its home jurisdiction, it received a "passport" to operate through the EU. All member states were obliged to accept services meeting minimum standards and accepted by the home country supervisor in the domestic market.

It was accepted that the approach which left national supervisors to set regulations would engender a "competition among rules." Rather than seeking to replace national supervision with supranational supervision, a gradual and experimental process has been taking place with new initiatives being tried, opinions changing and experience

shared. Some of the principal instruments used to advance the goal of integration have been EC directives, laws and policies. Thus, in 1993 the Second Banking Directive produced legally binding definitions of banking and further stated that any entity defined as a bank could engage in all of these activities. Other Directives have facilitated the expansion of investment services within Europe, the provision of insurance or the marketing of CIS, which met EC-approved standards. EU member states were obliged to modify domestic laws and regulations to implement the directives. The goal of the unified financial market in Europe with full capital mobility for 1992 and the subsequent Financial Services Action Plan were additional programs aimed at achieving the goal of a single financial market.

The fact that the EU members were able to transfer responsibility from national central banks to the European Central Bank (ECB) demonstrates that it is possible for them to make decisions to transfer authority to a central authority when the case for doing so is considered very strong. However, the political will to launch such a sweeping reform for financial supervision as well as for monetary policy was probably not present. Furthermore, given the wide divergence of legal and regulatory regimes and underlying attitudes and policies in the EU, it probably would not have been feasible to agree on the outlines of such a system.

2. Present Characteristics of the Financial System in Europe

As a result of the factors described in the preceding section, the European financial market has developed some distinctive features. Among these, six characteristics merit extended consideration.

1. The emergence of multipurpose financial institutions
2. Consolidation of institutions
3. Growing pan-European activity
4. Continuing problems in market integration
5. Differing institutional structures for financial supervision.
6. EU efforts to promote financial integration

The emergence of multipurpose financial institutions assuming complex risks

Owing to deregulation and increased competition, financial institutions now may engage in a broad range of activities and are increasingly free to select the specific mix of products that best matches the demand of the final users of services. The earlier highly regulated environment tended to perpetuate a banking system with excess capacity, with margins that could not be sustained in a deregulated environment. Additionally, highly regulated financial systems often contained many institutions, such as building societies, state-owned banks, savings banks and credit cooperatives that were assigned designated market segments and not subjected to intense competition. Increasingly the trend is to convert such institutions into banks and to open their protected market segments to competition. Simultaneously, banks have accepted the shareholder-based paradigm of bank governance and were subjected to rising competition from an internationalized market and expected to produce competitive returns.

The dominant institutional model in most financial markets is evolving towards an integrated financial service provider offering the full spectrum of commercial banking and capital market products and assuming the risks inherent in both category of operation. European countries have generally not made as sharp a distinctntion between banking and capital market operations, as the United States or Japan. However, in many cases the model of universal banking, when combined with restrictive attitudes toward risk and innovation, effectively resulted in domination by banks with a relatively narrow range of capital market products.

In the present internationalized environment, major banks in all countries engage in the full range of capital market activities. Furthermore, many capital market operations are of a non-traditional nature and do not correspond to the usual categories of publicly offered securities. Recent years have witnessed the growth of hedge funds, private equity partnerships and instruments such as collateralized debt obligations (CDOs) that are not available to the general public and hence are subject to less supervisory scrutiny than more conventional instruments. Commercial banks, which typically receive officially insured deposits and may be considered systemically important, increasingly assume risks in capital markets, including unsupervised segments of the capital markets.

In addition to capital market operations, many banks have begun to expand into the insurance sector, in the phenomenon known as “bancassurance” or “Allfinanz.” There are several rationales for the expansion from banking into the insurance business. With deregulation financial institutions have begun to expand offerings of products that do not fit neatly into existing categories of banking, securities, or insurance. Thus, some insurance products bear close resemblance to investment products such as CIS, but have additional tax advantages. Many banks believe that their existing distribution networks can be used to market investment or insurance products to banking customers, since demand for instruments such as CIS and insurance products has been growing faster than demand for traditional banking products. Moreover, one of the fastest growing segments of the market is financial planning and counseling and asset management. When proposing personal investment strategies to clients it is virtually indispensable to be able to include insurance products among those offered.

In many cases, the shift of the product mix to include a larger component of insurance products has simply involved banks using their branch networks to distribute insurance products to bank customers with little assumption of typical insurance risk. In other cases, however, banks have begun to assume solvency risks typically assumed by insurance companies, albeit via separately capitalized subsidiaries. As a result, there are now in Europe a number of sizable financial conglomerates that assume the full range of risks associated with the banking, securities, and insurance businesses.

Consolidation of institutions

In all markets a process of consolidation is underway, with the number of institutions diminishing and the size of institutions rising. Deregulation has exposed many institutions that previously had protected market positions to rising competition. In a market characterized by excess capacity and pressure on profit margins, one of the strategies that banks are adopting is to grow so as to achieve a dominant market position. Although support for the proposition that larger banks are more profitable is tenuous, many banks are pursuing such expansion strategies. Furthermore, partly in the belief that domestic banks need to achieve critical size in order to survive in more competitive markets, national regulatory authorities are adopting more positive attitudes toward domestic consolidation.

Until recently, many European countries were reluctant to permit acquisitions of sizable domestic banks by foreign banks. Resistance was especially strong with regard to the foreign acquisition of banks with large retail networks. However, partly owing to a stronger EC stance in favor of liberalization, it has become easier to obtain approval for cross-border mergers and acquisitions as well. This trend has gathered momentum in the past few years, with foreign institutions having acquired top tier domestic banks with extensive networks in major European markets.

The growing importance of intra-European activity

Due to geographic and cultural proximity as well as the efforts to foster the development of a single market in financial services, many financial institutions have been expanding in other EU countries and a large share of their business is conducted within Europe but outside their home market. Thus, while Europe has not achieved full financial integration, it is meaningful to speak of there being a significant number of financial institutions that have in effect become pan-European.

European integration is most advanced in wholesale financial services and capital markets operations. The European government bond market, which had achieved a high degree of integration before EMU has become even more integrated with the common currency. Substantial integration has already occurred in other bond market sectors such as covered bonds.

Market participants in Europe have great flexibility to list and to execute primary and secondary market operations in the marketplaces of their choice. Particularly with respect to securities operations, issuers, investors and intermediaries will seek to do business in the supervisory environment that provides the best mix of market integrity (or investor protection) and flexibility. Large corporate entities seeking capital can have access to intermediaries and investors throughout most of the European region while investors now hold pan-European portfolios of bonds and equities. Investment houses perform analyses of European investments on a sector-by-sector rather than a country-

by-country basis. Competition for listings and for order flow occurs among European exchanges and between the recognized exchanges and alternative trading systems. [2]

On balance, the progress toward market integration has advanced to the point that a qualitative transformation has occurred. For example Schoenmaker and Oosterloo (2006) analyzed the overall position of the 30 largest banking groups in the EU based upon the distribution of their assets in 2003 (See Figure 1). Of these, 17 were characterized as domestic and 4 as global, while 9 were primarily "European" inasmuch as a large share of their operations are conducted outside of their home markets but within Europe. Over time the trend has been for pan-European banks to rise as a share of the total while shares of both domestic and global banks decline. Given the trend of rising cross-border acquisitions of banks with retail networks in subsequent years, the importance of pan-European institutions has almost certainly risen further.

There are several variations in the general pattern of intensification of intra-European financial activity. Some financial institutions simply have developed extensive banking networks throughout the EU. In fact, most banks are deepening their presence in other markets through acquisitions. Thus, the banks' European exposure is likely to be concentrated in those countries in which major acquisitions have been made. Given the importance of major cross border acquisitions of banks with retail networks in recent years, this pattern of intra-European expansion may gain importance in coming years.

Some banks have extended operations outside their home markets inside a sub-region of the EU. The Bank Nordea, which operates in several Nordic countries but does not conduct business extensively elsewhere in Europe, would fall into this category. Similarly, Fortis operates predominantly in the Benelux region.

In the case of EU transition economies, the former socialist banking systems were re-capitalized and modernized using the capital and skill provided by foreign banks, mainly banks headquartered in EU countries. As a result, the majority of banking assets in EU transition economies are in foreign controlled banks with final supervisory responsibility for these institutions mainly in the hands of supervisors who are located outside the

[2] For a discussion oh how far integration has advanced in various components of the financial markets, see Hartmann, Maddaloni and Manganelli (2003).

domestic economy. Thus, financial officials in transition EU countries have some concerns about the fact that they have only limited control over the banks that constitute the largest share of their domestic banking systems. Conversely, banks in a few countries, (e.g. Austria) have extensive operations in EU transition economies as well as in some countries that are not yet EU members. In some cases the amount of assets of domestic banks held outside the home country exceed those held in the country. Moreover, the banks in question may have greater systemic weight in the host jurisdiction than in the home jurisdiction.

Many banks conduct wholesale activities, especially capital market operations, in financial centers in the EU, with London most prominent. Partly as a result, the United Kingdom accounts for a disproportionately high share of financial assets inside the EU.
A substantial proportion of the capital market exposure of banks in the most complex financial products is often found in entities located in financial centers.

Insurance business is usually undertaken through subsidiaries in each country. Supervision of insurance takes place on a solo (stand alone) basis.

Continuing problems in market integration in some sub-sectors

While there has been substantial integration of wholesale markets, one can still point to several segments of the market where less progress has been made in developing a unified financial market. For example, housing lending is a market that remains dominated by domestic banks with products differing significantly among markets and only limited international competition. More generally, retail finance in all forms has been much more resistant to market integration than wholesale finance. Some retail market segments where international institutions have only made limited inroads include consumer finance, retail investment services such as collective investment schemes (CIS) and insurance.

Among the factors that are frequently cited as inhibiting international business in the retail sector are different consumer protection laws across EU countries, tight control by domestic institutions over retail distribution networks (especially bank branch networks), and difficulties in offering financial products without an established presence in local markets. Thus, while gains in developing a unified financial market are substantial, considerable further progress must be made before a truly unified market is achieved. The wave of cross-border acquisitions of major retail banks may spur integration in this sector as well.

Divergent institutional structures for financial supervision

Over the past decade or so, a number of EU countries have implemented changes in the regulatory or legal frameworks governing their financial services sectors, while others have actively considered such changes. These changes have reflected efforts to realign organizational structures with changing market realities, specifically, 1) a convergence of products among previously separated sectors, and 2) the emergence of groups that offer a broad range of financial services.

These developments have necessitated a reassessment of existing regulatory models that had been based upon earlier patterns of segmented financial markets and supervision. Some countries, such as the United Kingdom and Germany, have consolidated all financial supervision (with some exceptions, such as private pensions in

the case of the UK) in a single entity. In most countries adopting the unified regulator model, responsibility for banking supervision is removed from central bank, whereas in most cases, the central bank previously had held such responsibility.

To some degree one can speak of there being a trend toward consolidated supervision, but it is not accurate to say that there is a clear consensus in favor of the unified supervisor. Many EU countries, such as France and Italy, have separate supervisors for each category of financial service while others (e.g. the Netherlands) undertook a major reassessment of financial supervision and opted for a realignment of responsibilities, but without a unified supervisor and with an active role for the central bank in supervision. (Lumpkin, 2002.)

EU efforts to deepen financial integration

Observing that despite long-standing efforts to achieve integration further efforts were needed, the EU and its members have been taking a series off efforts to achieve a fuller degree of integration. In May 1999, the EC published a communication detailing the Financial Services Action Plan (FSAP), which was scheduled to begin in 2000 and to be completed in 2004. The aim of the FSAP was to complete the single market in financial services which would consist of 1) a single wholesale market, 2) an open and secure retail market without unjustified barriers to the cross border provision of services, and 3) state-of-the-art prudential rules and supervision.

The FSAP consisted of 42 measures designed to reduce barriers to the single market. In continuation of the long standing practice of subsidiarity, the actual implementation and interpretation of the measures of the FSAP were left to the discretion of the EU member countries.

It was recognized that, since divergent national interpretations of EU rules might hamper the emergence of a unified market, efforts would have to be accelerated to foster the coordination of supervision. One key innovation was the adoption of a new approach to securities supervision, the so-called “Lamfalussy arrangements under which a higher degree of harmonization could be achieved. The Lamfalussy approach involved four levels of rule making:

Level 1 consists of legislative acts such as directives or regulations of the EC adopted by the Council of Ministers and the European Parliament;

Level 2 consists of implementing measures adopted by the EC with the assistance of the European securities commission;

Level 3 consists of committees of national supervisory officials which have the function of communicating among officials and in order to achieve more consistent implementation of regulations. The European Securities Committee was responsible for coordination among securities supervisors; and

Level 4 involves joint efforts by the EC, member states and national supervisors to ensure implementation and enforcement of EU law.

The Level 3 committees are the main body in which national supervisors communicate and seek to implement rules coherently.

In December 2002, it was proposed that the Lamfalussy arrangements should be extended from the securities sector to banking, insurance, and pensions. This proposal was endorsed by the European Parliament in March 2004. Two new Level 3 committees were created, the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS.)

It should be stressed that all of these efforts at coordination remained within the parameters that guided earlier efforts at financial integration. The principle of subsidiarity continues to be respected. The Level 3 committees have no supranational authority and cannot issue binding rules. Their function is to facilitate communication and coordination among national supervisors.

3. Challenges for Financial Supervision in the Present Environment

As the foregoing discussion has argued, the present configuration of supervisory responsibilities in the EU arose from a combination of national supervisory reforms, market competition, global standards and actions on the part of the EU to promote a unified financial market. Two noteworthy characteristics of the present system are 1) The system is becoming very complex with institutions facing a large number of supervisors

in the EU, and 2) Divergences are appearing between the economic area in which the institutions operate and the area of jurisdiction of the competent supervisors. The divergence between the area in which an institution actually operates and the area of responsibility of its supervisors is already causing problems in the ongoing supervision of cross-border institutions and could have an even more deleterious impact in times of crisis.

The EU continues to take measures to promote integration o both wholesale and retail levels. Thus, in November 2007 a revised Directive on investment business, known as the MiFID, Directive took effect. In December 2007, the Commission released a “white paper” on mortgage finance. Proposals to facilitate the expansion of cross border consumer finance business are under consideration.

The growing complexity of supervisory responsibility is a serious issue

As financial institutions expand into other European markets they must deal with a growing number of supervisors. For most supervisory purposes, branches are treated as simple extensions of the head office and thus the home country supervisor has clear responsibility. (However, in an exception to the general principle of home country supervision, foreign branches are subject to host country supervision for liquidity control.) The situation is more complicated with respect to subsidiaries. Current rules, both within the EU and in the Basle context, stipulate that when an institution establishes as a subsidiary, the host supervisor is responsible for oversight of the local entity, with the home country supervisor accepting responsibility for the entity as a whole. In EU terminology the supervisor with responsibility for the Group is designated the Consolidating Supervisor (CEBS, 2006)

Although EU rules permit establishment in either form, many financial institutions choose to establish as local subsidiaries rather than branches. Several motivations are possible for choosing to establish as a subsidiary. In general, the greater the degree to which the institution wishes to isolate the local entity and its balance sheet from the head office the more likely it is to choose a subsidiary form. In commercial banking, subsidiaries are sometimes formed to engage the local authorities in the supervision of the local activities of the institution. This may be an important consideration in cases where a foreign

controlled bank is systemically important in the local market. Financial institutions may choose to form local capital market subsidiaries if they intend to deal extensively in a particular capital markets and wish to involve the local supervisors in market oversight.

Financial conglomerates almost always conduct insurance business through subsidiaries, and it is the strong preference of the insurance industry (and of insurance supervisors) to operate in this way. It is an accepted principle that insurance subsidiaries should be supervised on a “solo plus” basis, i.e., the insurance subsidiary should be assessed primarily on its ability to stand alone regardless of the financial standing of the entire group. This principle has remained in effect despite the tendency to consolidate supervision for other financial activities at the group level. In fact, major Pan-European institutions usually have networks comprising branches and subsidiaries throughout Europe through which they engage in a range of commercial banking and capital market activities, and frequently in insurance activities as well.

A growing number of analysts and practitioners contend that present supervisory arrangements have serious deficiencies. The basic criticisms can be summarized as follows:

1. The set of rules governing the distribution of supervisory responsibility now diverges significantly from the ways in which major financial institutions organize themselves and manage their risk. When the financial situation is operating normally, the distribution of responsibility among home (or consolidating) and host supervisors already creates much complexity in risk management and regulatory compliance.
2. In times of stress the system allocates responsibility to support fragile or failed institutions in unpredictable ways that does not necessarily enhance systemic stability or provide for equitable treatment of institutions and other stakeholders. The home supervisors as well as other officials that would be involved in rescuing and/or resolving financial institutions are responsible for the stability of their markets and protecting the interests of domestic taxpayers. Furthermore, there is no mechanism by which the funds for major operations can be raised and allocated except by national governments.

Supervision under Normal Operating Conditions

In the past financial supervision usually entailed close inspection of banks' portfolios and/or market conduct practices. In present conditions the trend among supervisors is to be sure that institutions hold capital that is adequate to support the risks assumed that they have established adequate risk management systems and that senior management and boards are taking necessary measures to understand and to oversee in-house risk management systems.

Global principles of banking supervision, particularly under the Basle accord of 2004 (Basle II), enable the bank to set up a system to measure various kinds of risk (credit, market, liquidity etc.) and to hold capital against various risks for the entire institution. Basle has always emphasized the central role of the home supervisor. The Committee of European Banking Supervisors reaffirmed this position in an EU context in by issuing "Guidelines for Cooperation between Consolidating Supervisors and Host Supervisors" (CEBS, 2006).

These Guidelines were based upon the EU's Capital Requirements Directive (CRD) which is designed to assist supervisors in their assessment and validation of banks' internal risk management models. The CRD and the CEBS Guidelines assume that the process of oversight is a cooperative venture between the consolidating supervisor and the host supervisor. The Guidelines support joint model validation under the lead of the consolidating supervisor and call for written agreements for coordination and cooperation between home and host supervisors. Reflecting these policies, a pan-European entity will be subjected to the jurisdiction of a number of entities throughout the EU, each having a set of concerns specific to the local market and to their specific line of business.

Many financial institutions voice discomfort with the need to deal with more than 20 supervisory authorities. The concerns of each supervisor may differ. Thus, while banking supervision has traditionally been concerned with the quality of each bank's balance sheet and risks of illiquidity and insolvency, securities supervision has traditionally been concerned with conduct of business and investor protection issues and insurance supervision has emphasized solvency and consumer protection. Within any country,

supervisory authority may be centralized in a single entity or dispersed among two or more entities.

The host supervisor has responsibility for the activities of the local subsidiary, including the validation of the local subsidiary's risk management systems. However, the local supervisor may have an imperfect view of the institution's overall risk profile. In a simple example, the institution may have considerable cash or derivatives exposure to a given market segment in one subsidiary, which is offset by another cash or derivative position elsewhere in the organization. The host supervisor might object to excessive local risk while the home supervisor will have a clearer perception of the institution's overall risk profile. Many bankers report that differences in views between home and host supervisors are slowing the process of introducing integrated risk management models. In some cases, the supervisor responsible for the local subsidiary may not be able to understand the entire risk management system or may object to the specific risk profile assigned to a local subsidiary.

In any event, most observers believe that in practice the distinction between branches and subsidiaries has narrowed considerably. Both market practice and global supervisory principles now tend to minimize the significance of the difference between these two types of establishment. In fact most financial institutions manage their funding, investment and risk management on a consolidated basis, regardless of whether local affiliates are branches or subsidiaries. Decisions to locate various functions, such as funding, liquidity management, risk management and credit decisions in specific points of competence in the organization are made in order to benefit from specialized knowledge and economies of scale.

In analyzing the management of major risks in the banking, insurance, and securities sectors, a study by the Joint Forum on Financial Conglomerates surveyed 31 large financial institutions in 12 jurisdictions (Joint Forum, 2003). Two of the most important trends identified were (1) greater emphasis on the management of risk on an integrated firm-wide basis, and (2) related efforts to aggregate risks through mathematical risk models. The study concluded that the trends reflect the interest of institutions in understanding better the variety of risks that they face, thereby enabling them to

determine more accurately the amount of capital needed to operate their businesses in a prudentially sound manner.

There is a growing consensus that it is very difficult to isolate a local subsidiary from financial difficulties in the parent institution or vice versa. In practice it would be difficult for a local subsidiary to survive insolvency of the parent institution or for a parent to be insulated from the impact of insolvency of a subsidiary. While the institution theoretically has the option of converting subsidiaries to branches, it is not desirable to reject the subsidiary form of establishment simply to avoid the added regulatory burden.

The rules by which supervisory responsibilities are divided between home and host supervisors often lead to anomalous situations. In particular, the economic area in which an entity an entity operates often diverges significantly and in unpredictable ways from the geographic area in which the supervisory authority operates.

The various EU instruments related to supervision recognize that institutions manage their risk and capital in a centralized fashion and, thus, there is provision for cases where consolidated or host supervisors cannot reach agreement. Nevertheless, current EU rules continue to allocate a substantial direct role to host supervisors and attempt to reduce differences by transparent guidelines and better information sharing, rather than by any fundamental realignment of supervisory responsibility. Many institutions that are active in the market believe that the system is already cumbersome and that it adds unnecessarily to the regulatory burden on financial institutions without any tangible benefits in terms of enhanced stability.

The Functioning of the System under Stress Conditions

In addition to providing a simple and efficient supervisory framework in normal market conditions, a supervisory system should also provide the most effective means to minimize major systemic disturbances and to provide an adequate capability to deal with such systemic strains when they arise. In the past two decades a number of incidents have occurred in financial markets in which turbulence has arisen in one or more sectors of the financial system requiring action by the authorities to assure continued functioning

of the market, to contain potential crises and /or to resolve crises that have already occurred.

Although this paper uses the generic term “crisis”, crises are not homogeneous events. Some occurrences of strain or potential crisis can occur quickly and the problems can be addressed by prompt action by an institution with the clear authority to act. Such an instance would be the provision of large volumes of liquidity in a very short period such as those supplied by the Federal Reserve in the October 1987 equity market drop or by the ECB at the time of the terrorist attacks of September 11, 2001. other actions can involve more than one institution and take place over a longer period, such as the provision of finance by central banks during the market turbulence that began in the sub-prime housing sector in the United States during the summer of 2007. Still others can be complex and prolonged and involve more than one public institution and the expenditure of public funds, such as the resolution of the Nordic banking crises in the early 1990s. Consequently, the resilience of the system under stress must be considered in the light of its capacity to respond to a wide range of possible stresses.

Following the end of the tech bubble in 2000-2001, supervisors, governments and private market participants became progressively more sanguine about the capacity of the financial system to manage risk and to contain instability. Thus, concern with the resilience of the system in times of stress diminished considerably. During 2007, however, the financial turmoil that began with the sub prime mortgage sector in the US lead to the insolvency of a number of medium sized financial institutions in Europe and has led to losses on the part of major capital market players that required significant recapitalization efforts. Thus it is fair to say that concern with the stability dimension of financial supervision has risen appreciably in the past year.

It is important that the relevant institutions are given sufficient legal power to enable them to address the problems adequately and that the distribution of legal mandates contributes to systemic stability. At times of stress, such as when the ECB decided to supply liquidity to markets or when the authorities in the Nordic countries faced widespread banking insolvency, the public agencies were all making decisions in accord with mandates given by lawfully constituted authorities. Of course, any decision can be questioned at the time it is made or subsequently. However, one expects those

responsible for making decisions to have a legal mandate that provides a solid basis for the decision. If the system assigned supervisory mandates in ways that could have the end result of encouraging important institutions to act in ways that detract from systemic stability or in ways that leave important market sectors exposed to destabilizing pressures, there would be grounds for concluding that the system required adjustment.

The financial supervisor usually operates autonomously under normal conditions. By contrast, in times of stress the financial supervisor typically functions as part of a network of officials that are sometimes described as “the safety net.” Other key elements of the safety net are 1) the national central bank, which as lender of last resort must decide whether and how to intervene in the market, 2) the system of deposit guarantees and insurance and 3) ministries of finance, which must make decisions concerning the expenditure of public funds, subject to approval by the legislative authorities. In the eurozone, the ECB is another key part of the safety net.

The Guidelines of the CEBS mentioned above specifically do not address issues related to the safety net. However, as Goodhart has persuasively contended, a discussion of the adequacy of supervisory arrangements automatically requires a discussion of the safety net. (Goodhart, 2004.)

When a given institution comes under pressure, the home supervisor in consultation with the national central bank must make a determination as to whether the institution faces a simple liquidity shortfall or is insolvent. Often, it is not possible on short notice to determine with any considerable degree of certainty whether the institution is actually illiquid or insolvent and hence a decision will have to be made with incomplete information. During the market turbulence during the summer of 2007, the ECB supplied considerable liquidity to the market, but these operations involved short-term advances against good collateral, not a decision to support institutions with poor or doubtful prospects. In other circumstances, a national central bank may have to bear the risk of not being able to recover the funds provided to the institution.

In the later stages of a banking crisis when it is clear that the institution is not solvent, the supervisor and the central bank as well as the finance ministry and those responsible

for the system of deposit guarantee or deposit insurance will have to decide how to deal with the problem.

One component of the safety net is the system of deposit guarantees and deposit insurance. All EU countries now have deposit insurance schemes, but these schemes differ substantially in terms of amounts of coverage, and methods of financing payments. Some schemes cover deposits in foreign currencies while others do not. A summary of European deposit insurance schemes is presented in Table 1. An EU Directive has set certain minimum standards for deposit insurance, but levels of guarantee vary widely. Essentially, deposits at branches are covered by the deposit insurance scheme of the home country while those of subsidiaries are covered by the schemes of the host country. There are provisions whereby subsidiaries in countries where protection is higher than in the home country can buy additional protection under the host country's scheme. There are also provisions for entities that convert from subsidiaries to branches.

The financing characteristics of the schemes vary significantly. Some schemes include government guarantees while others provide insurance based upon collective agreements among banks. Some schemes are funded in which case there is typically a pool of assets that is capable of repaying a certain amount of deposits. Other schemes are not funded meaning that solvent banks and/or the government have a contingent obligation to provide funds to compensate insured depositors. In countries where the deposit insurance scheme is funded by the banks, banks established in the domestic market (i.e. domestic banks and subsidiaries of foreign banks) may be obliged to bear part of the cost of resolving a failed institution.

In a crisis, decisions will have to be made on issues such as whether to recapitalize institutions, to divide the institution into viable and non-viable entities and to sell viable units of the institution to suitable investors. Decisions must also be made concerning the allocation of losses. In the event that institutions come under stress, the effort to mount a rescue and/or to resolve the institution will involve cooperation on the part of the supervisors (who may be unified or separated) as well as the central banks, the deposit

Table 1

Deposit Insurance System in EU Countries, end-1998

Country	Date established	Ceiling on coverage	Foreign currency Deposits Covered?	Interbank deposits	Administration(1)	Funding
Austria	1979	20,000	No	No	private	unfunded
Belgium	1974	15,000 *	No	No	joint	funded
Denmark	1988	40,000	Yes	No	joint	funded
Finland	1999	25,000	Yes	No	private	funded
France	1980	60,000	No	No	private	unfunded
Greece	1995	20,000	No	No	joint (3)	funded
Germany	1966	20,000 (2)	Yes	No	joint (3)	funded
Ireland	1989	15,000 *	No	No	government	funded
Italy	1987	103,291	Yes	No	private (CB approves decisions)	unfunded
Luxembourg	1989	12,500 *			private	
Netherlands	1979	20,000	Yes	No	government	unfunded
Portugal	1995	25,000	Yes	No	government	funded
Spain	1977	*	Na	No	joint	funded
Sweden	1996	28,000	Yes	No	government	funded
United Kingdom	1982	22,200	No	No	private	mxed (4)

1) The government includes the central bank.
2) The public scheme provides coverage up to 20,000 , but the private scheme provides coverage up to 0.3% of the liable capital of the bank for each depositor.
3) “Joint”: both governmental and private
4). There is an initial contribution and ex post funding when needed.
.
*20000 € from 2000

Source: Schoenmaker and Oosterloo (2006)

insurance systems and the ministries of finance of several countries. The official institutions involved will have to exchange information, decide upon immediate support measures as well as a longer term course of action and allocate the costs of any solution among themselves, i.e. burden sharing. These efforts could entail high levels of expenditure. Some measures may have to be introduced rapidly under crisis conditions while others may have to be taken in steps over an extended period of time.

In recent years, a number of initiatives have been taken to improve supervisory cooperation and set some guidelines for crisis management. In that context, a number of memorandums of understanding (MOUs), on bilateral, regional (e.g. among Nordic countries) and European levels, have been signed. MOUs specify basic principles and provide for cooperation to clarify responsibilities and to provide for exchange of information and assessments among official bodies responsible for financial oversight authorities. These MOUs cover both routine supervision and situations of crisis management.

These MOUs decidedly represent a step forward and they seem to operate satisfactorily under normal conditions, although they clearly have not led to resolution of disagreements between home and host supervisors. It is less clear how effectively these instruments would function in a crisis involving large cross-border institutions. MOUs are not legally binding and are open to considerable interpretation by individual countries. Thus, current rules oblige supervisors to share assessments, but when there is a serious prospect that large losses will have to be assumed assessments can be framed so as to reflect the interests of each country.

National Mandates for Internationally Active Institutions

In an earlier section it was noted that the present distribution between home and host supervisors may lead to rigidity and excessive regulatory burdens in ordinary times. With respect to the operation of the system under stress conditions, it is possible that the configuration of mandates of supervisors and other agencies responsible for the safety net tends to give rise to potential conflicts of interest.

Under the current rules, the financial supervisor, the central bank, and the finance ministry all receive their mandates from national legislatures and their mandates are

framed in terms of the protection of domestic investors or protection of the integrity of the domestic market or of the soundness of the domestic banking system. Thus, national central banks are mandated to assure stability in the domestic financial market and finance ministries are tasked with minimizing the cost of bank resolution to domestic taxpayers. To the degree that governments support deposit insurance schemes, they will normally seek to minimize the cost to domestic taxpayers.

In the case of institutions whose activities transcend one country, a decision to recapitalize or to close a bank will be taken by officials in the home jurisdiction. These officials are mandated to act in the name of the taxpayers of the home country but the impact of their actions will be felt by stakeholders in other countries. Thus there is a risk of misalignment of interests. Even if supervisors, central bankers and finance ministry officials were all to agree that the present situation is anomalous, during a crisis they would be obliged to follow their mandates. Given the large amounts of public funds at stake, they would have no legal basis to do otherwise.

Even if an agreement were made that decisions to support or resolve a troubled institutions should be made on the basis of the institution's entire operations, and not simply on the basis of the home jurisdiction, there are no provisions to allocate the costs of such an operation. The absence of agreements on the principles under which operations should be undertaken prior to the onset of a crisis makes it less likely that an equitable solution will be found during a crisis.

In an earlier section it was noted that major financial institutions seek to centralize key decisions regarding investment and risk management in their head offices and that this approach is broadly consistent with the thinking of financial supervisors. On balance, financial efficiency, sound risk management and effective supervision would argue in favor of placing responsibility for in-house risk management and the prudential soundness of the institution in the head office and all responsibility for supervision of the institution to the home supervisor. At the same time, if a proposal were made to transfer all decision making authority to the head office of the institution and all supervisory authority to the home supervisor, officials in host countries might understandably be hesitant about transferring authority to a foreign supervisory authority with an explicit mandate to defend its own national interest. The host supervisor would prefer a structure

that preserves some measure of local influence over decisions taken by foreign authorities, even if that structure is not the most rational. For example, when a large share of banking assets is controlled by foreign banks (as in EU transition economies for example) the host country often will strongly prefer that the bank incorporate as a local subsidiary in order to gain some degree of supervisory control over banks that are systemically important in the domestic market.

As the process of consolidation and cross-border acquisitions gains momentum many EU countries may face the possibility of a large share of bank assets being under the control of foreign banks and with supervisory responsibility for a large share of a country's banking system located outside the home country. At the same time, home country supervisors may be in charge of financial institutions that conduct most of their operations abroad and where most risk is located outside the country. Likewise, when an institution operates through a subsidiary in a second country with borrowers or counterparties in a third country, it will create situations in which the authorities of the host country may face the prospect of expending resources in operations which have no inherent connection to their domestic economy or financial system.

These misalignments mentioned above are not unique to Europe. EU rules governing the distribution of responsibilities among supervisors in Europe are based upon long-standing global principles of financial supervision. However, cross-border financial integration has advanced farther in Europe than in any comparable area of the world. In addition, since Europe has the explicit aim of developing a fully integrated financial market the more progress is that is made in achieving financial integration, the more striking will be the contrast between pan-European institutions and their national mandates.

No one can predict with great confidence how events might unfold in a crisis. However, if a crisis were to begin under existing rules and uncertainties, supervisors and other key actors in individual countries may have no alternative but to seek to minimize the burdens on their own markets, institutions and citizens.

There is considerable support for the proposition that this is how countries are likely to react to crises situations. Analyses by Freixas (2003) and Schoenmaker and Goodhart

(2006) indicate that home country supervisors operating under national mandates will tend to underestimate the cross-border impact of a bank failure. The European Shadow Financial Regulatory Committee held that the risk of shifting positions among banks' branches and subsidiaries in order to take maximum advantage of the safety net is high. (ESFRC, 2004 and 2006.) In its 2007 Article IV Consultation on the Euro Area, the IMF staff concluded that in a crisis the most likely outcome would be for national supervisors and other national authorities to seek to protect national interests and especially to minimize the cost to their own treasuries (IMF, 2007a and 2007b). If the authorities in any country were seen as resolving the crisis in a way that favored domestic interests to the detriment of interests of other EU countries, the concept of a single European financial market would be dealt a severe setback.

4. Proposals for Reform

The preceding section pointed out the major anomalies in current supervisory arrangements. Analysts and market participants have called attention to the flaws in the system and formulated a number of proposals for reform. This section reviews the main proposals for reform.

Four elements are commonly found in reform proposals:

1. Centralization of supervisory authority for each institution in a designated single entity, regardless of whether local presences are in the form of branches or subsidiaries. There are two basic variants of the proposal, a) a unified EU-wide financial supervisor, or b) a "lead supervisor" selected from among existing supervisors. In some proposals, the lead supervisor is seen as the precursor of a unified EU financial supervisor.
2. A revised European mandate for financial supervision to be used by the designated supervisory authority.
3. A decision-making structure in which all EU countries would be able to have some influence over decisions; and
4. An EU funding mechanism with provisions to support any expenses incurred in connection with operations of the safety net.

Table 2 gives a summary of the major proposals for reform. It is convenient to date the starting point for the policy debate with a speech in 2000 by Rolf Breuer, spokesman of the supervisory board of Deutsche Bank, in which he called attention to the growing disparity between internationalized financial markets and national supervision and called for specific remedies (Breuer, 2000.) The basic criticisms and the terms in which Breuer framed the issues are still largely used today.

Breuer argued in favor of a single European financial services supervisor that would assume responsibility for banks that are active on a European scale, while national supervisors would continue to supervise banks with mainly domestic orientations (See Figure 2). The EU Supervisor would have a federal structure inasmuch as it would be composed of representatives of national supervisory agencies. The EU supervisory authority would be independent of the ECB.

Breuer's proposal for reform was taken up by the European Financial Services Roundtable (EFR) in 2004 and again in 2005, which elaborated a specific argument in favor of the lead supervisor concept (EFR, 2004 and 2005). Instead of seeking to create a new EU supervisory authority, an existing national supervisor would be designated as the lead supervisor of each bank. Generally speaking, the lead supervisor would be the supervisor in the institution's jurisdiction of domicile. The lead supervisor would be responsible for coordinating all aspects of supervision of both branches and subsidiaries in the EU. The lead supervisor would be the single point of contact for all reporting schemes. It would validate and authorize internal models, approve capital and liquidity allocation, approve cross-border set-up of specific functions and decide about on-site inspections. Furthermore, the lead supervisor should not only be responsible for supervision on a consolidated level, but also on the solo and sub-consolidated level.

The lead supervisor would also act as the EU coordinator in discussions with non-EU jurisdictions. While the lead supervisor would have a considerably enhanced weight, especially relative to host country supervisors in which the institution operates as a subsidiary, the authorities in those countries would have a mechanism to influence the policies of the supervisor. The EFR envisaged the formation of a "college of supervisors" composed of supervisors from all of the jurisdictions in which the institution has significant operations. Although it is not legally required to acknowledge the supervisors

in countries where the institution only has branches, the EFR recommended that supervisors in countries where the operation operates through branches also be included in the college of supervisors. In cases of disagreement among supervisors with the college, the EFR recommended a mediation procedure.

In times of crisis, the broader college of supervisors would give way to a smaller core group composed of supervisors from jurisdictions where the market impact of the group is significant. The core group would act in cooperation with other official bodies that form part of the "safety net", such as central banks, deposit insurance agencies and ministries of finance. The lender of last resort for each institution would be the central bank in the country of the lead supervisor. The EFR suggests that the EC propose a model deposit insurance scheme and the countries of Europe be encouraged to converge toward the suggested model over time. Allusions are also made to the need to allocate the fiscal costs of any action, but no specific recommendations are made.

The original EFR proposal did not specifically require the lead supervisor to incorporate the cross-border externalities of a failure of a financial institution into its decision-making. The EFR proposal of 2005 partly rectified this omission. Finally, the EFR acknowledged that its proposals would mostly be valid in the medium term. For the longer term, a move toward an ESFR was seen as a better solution.

Dirk Schoenmaker and Sander Oosterloo have suggested a further refinement of the lead supervisor concept (Schoenmaker and Oosterloo, 2006). Like Breuer and the EFR their plan recognizes the need to move to a regime of supervision that is consistent with the level of intra-European financial integration that has already been achieved and with the centralized risk management systems already in use in most institutions. Their plan was also partly formulated to overcome the objection by many critics that while the mediation mechanism is proposed in cases where lead and host supervisors disagree, in the final analysis authority is transferred to the lead supervisors. Schoenmaker and Oosterloo agreed with other commentators that national mandates to protect domestic interests were another weakness of the present system.

To overcome these deficiencies, Schoenmaker and Oosterloo recommend a new EU mandate for financial supervision, while execution of supervision would be left in the

hands of national supervisors. Under an EU mandate, the same lead supervisor would operate inside a framework that stipulates that the supervisor is expected to safeguard the stability of the EU financial market as well as depositors and taxpayers throughout the EU.

This new supervisory regime would be supported by new EU-wide mechanisms for decision making and crisis management. Parallel to their call for an EU-wide mandate for financial supervision, Schoenmaker and Oosterloo propose a European system of Financial Supervisors (ESFS). Their model of the ESFS, which is shown in Figure 3, would consist of a small Executive Board and the national supervisory agencies of all EU states. It would have a federal structure, similar to that of the European System of Central Banks (ESCB).The proposal is similar to that of Breuer, except that Breuer proposed that the European Financial Supervisor would take direct responsibility for all pan-European institutions while under this model supervision would be exercised by national supervisors. In the case of pan-European institutions they would be acting as lead supervisors executing an EU mandate under the ESFS. The same supervisors would continue to supervise purely national institutions under their national mandate.

The position of host country supervisors in countries where the institution has subsidiaries is somewhat enhanced versus other systems. As in the Breuer and EFR proposals, the proposed system would effectively remove the distinction between branches and subsidiaries. Thus, the host country supervisor would no longer have the capability to interfere directly in the ongoing process of supervision but would gain a more secure place in the decision-making structure as part of the ESFS. The position of a host country supervisor would be somewhat analogous to the position of a European central bank participating in the ESCB. Before the introduction of the common currency there may have been some nominal independence but the practical margin of freedom of most central banks was negligible. After EMU all euro-zone central banks can have some (admittedly minor) impact on the common monetary policy of the ECB.

Assuming that a decision is reached regarding the proper regulatory response to a failed institution, any solution will involve fiscal costs and some method must be devised to distribute the costs of such actions. In addition to the realignment of supervisory roles, Schoenmaker and Goodhart (2006) argue that proposals for realignment of supervisory

authority must address the issue of how the costs of rescuing and resolving banks after a crisis are to be distributed. This issue is especially acute because there is no common European fund from which resources can be drawn for these purposes.

Schoenmaker and Goodhart propose an EU-wide system of explicit rules that would guide EU central banks and finance ministries in determining the form of future bank rescues and recapitalizations. They also argue that it is not possible to make decisions about an appropriate strategy to deal with a failed institution without estimating how much the operation will cost and how the costs will be distributed. Accordingly, they recommend an ex ante formula for distributing the burden rather than ex post negotiations. There are two basic conceptual bases for burden sharing during bank resolutions, one based upon each country's share of total EU financial assets and a second that assesses countries contributions based upon each country's share in the total assets of the failed institution. Schoenmaker and Goodhart argue that the second approach would provide a superior alignment of incentives inasmuch as the countries that benefit from the resolution would contribute to the resolution in proportion to their share of the bank's activity. Of course each of these methods of assessing the funds is open to criticism and in the end some compromise formula could be accepted. Finally, Schoenmaker and Goodhart propose a decision making structure under which decisions to activate the safety net would be made. EU legislation would mandate that the institution be resolved in the least costly way possible in order to reduce the discretion of the authorities managing a crisis to a minimum.

Schoenmaker and Goodhart estimate the total costs of possible rescue scenarios under various assumptions about the size of institutions, the gravity of the crisis and the method by which the costs are allocated. Their estimates suggest that the costs of supporting a moderately large bank recapitalization would not place undue strain on the financing capacity of EU countries and would probably be politically acceptable. By contrast a systemic failure of proportions such as those witnessed in the Nordic countries in the 1990s would force the EU and its members into a situation that would strain its decision making processes. In fact such an event would strain almost any system. Schoenmaker and Goodhart recognize that it would be necessary to amend EU legislation to implement this plan, but argue that the existing rules of the EU make it possible to enact needed legislation.

In August 2007, Norbert Walter and Bernhard Speyer of Deutsche Bank Research issued a report that again considered the case for a reformed system of supervision (Walter and Speyer, 2007). Their proposal, which is essentially a refinement of the original Breuer proposal, calls for a gradual process of consolidation of oversight authority in a lead supervisor, eventually leading to a unified supervisor for all EU- wide financial institutions.

In summary, the solution proposed by Walter and Speyer consists of:

1. Improved coordination by and enhanced powers for Level 3 committees under the Lamfalussy process. The committees would have actual rule-making authority, as opposed to their present role as a platform for exchange of information among governments, and would be able to make decisions on the basis of qualified majority votes. Level 3 committees would have an EU wide mandate;
2. In the medium term the lead supervisor mechanism would be used for EU-wide institutions ; and
3. In the long run, the ESFS system would be introduced.

The authors first consider the possibility of a scheme under which the lead supervisor would chair a college of supervisors composed of the supervisory authorities from all countries in which the institution has significant operations. The lead supervisor would be the point of contact and would be the sole authority on questions such as model validation, pillar 2 issues and capital allocation. A mediation mechanism would be used in case of disputes between home and host supervisors.

Taking note of the shortcomings in the lead supervisor that have been noted by analysts in the past few years, the authors conclude that the use of the lead supervisor using national mandates might resolve some issues in the short run but that the best solution in the long term would be a federal ESFS for pan-European institutions. The ESFS would be independent of the central bank.

Unlike the Schoenmaker-Oosterloo proposal, which would leave actual supervision under the control of national supervisors with the ESFS in a coordinating role, the

Walter-Speyer proposal would create a new EU-level supervisor which would exercise supervisory authority for EU-wide institutions. Smaller institutions would continue to be supervised by national supervisors. The pan-European supervisor, which was tentatively called the European FSA (or EFSA), would be responsible for supervising all financial activities (banking, securities, and insurance).

5. The Environment for Reform

As the discussion in the preceding sections has made clear, market participant, policy makers and analysts have identified a number of potential shortcomings in the current arrangements for financial supervision in the EU and several interesting reform proposals have been formulated. Nevertheless, it is recognized that it will be difficult to introduce the changes in rules to move to a new system of supervision. One can identify six potential sources of resistance to changes of the kind proposed by reformers since 2000.

1. Conflicts with basic legal principles of the EU;
2. Concerns about erosion of national control;
3. Potential tension between increased European integration and increased integration into the global financial market;
4. Perceived benefits of regulatory competition;
5. Difficulties in agreeing on a specific alterative system; and
6. Belief that the present system has performed reasonably well.

The system has taken its current form partly due to its consistency with certain basic principles in the EU, especially the principle of subsidiarity, which means that authority should only be transferred to a higher level when countries can agree that the issue is not capable of resolution at the lower level. Beyond the strictly legalistic preference for decentralized solutions, there is an understandable reluctance to transfer decision making authority to higher levels, which are felt to be less accountable to electorates than national governments.

The present system of mutual recognition and home country control with mechanisms for coordination reflects the principle of subsidiarity as well as the present balance

between national and supranational authority in the EU. This principle has been reaffirmed as appropriate on several occasions. For example, the Guidelines for Cooperation between Consolidating Supervisors and Host Supervisors (CEBS, 2006) are specifically designed to be compatible with this overarching principle. Furthermore, present rules about the distribution of authority reflect global supervisory doctrine.

The fact that that EU members were able to transfer responsibility for monetary policy to the ECB demonstrates that it is constitutionally possible for them to make such decisions when the case for doing so is considered very strong. Nevertheless, national legislators are likely to be hesitant to cede authority to EU financial supervisor, owing to their concerns about the possible loss of control over decisions that have repercussions on many aspects of economic and social life. This can be contrasted to the decision to empower the ECB to conduct a common monetary policy. Arguably, once the political decision was made that the ECB is simply to pursue price stability, the means of achieving this goal were largely reduced to technical issues.

A persuasive case can be made that authority regarding financial supervision must reflect a wider set of concerns than monetary policy. Moreover, the specific concerns about which decisions must be made will change with time and thus national authorities will be reluctant to make an open-ended grant of authority to financial technicians. For example, at this time debates are under way about whether new products such as hedge funds should be regulated or under what circumstances certain investment products may be offered to retail investors. Financial regulation also has important repercussions for consumer welfare, economic security and for the protection of retirement income. Thus, at this time the United States Congress is raising the issue of whether the Federal Reserve should have been more vigilant in monitoring risks of financial institutions and markets and in protecting consumers during the expansion of sub prime lending in recent years. In view of the broad social and economic impact of financial supervision, national governments will require strong persuasion to relinquish decision-making authority for such matters to an EU supervisory body.

An additional justification for the present system is the belief that national supervisors and other national officials must retain sufficient capability to maintain stability in domestic financial markets and must also have the ability to protect the interests of

domestic taxpayers in the case when decisions are make to recapitalize or resolve troubled institutions. This argument is currently important in transition EU countries where most banks are foreign affiliated but could become more broadly significant assuming that, as expected, cross border consolidation in the financial sector accelerates.

Some analysts believe that efforts to strengthen collaboration at the European level detract from the ability of financial institutions to function on a global basis. Many institutions that are headquartered in European countries conduct significant parts of their global operations outside of their home countries, but outside of Europe as well, with activity focused in the Western Hemisphere, the Middle East or Asia. Such institutions face significant challenges in coordination of supervision, but mostly with supervisors outside Europe. Many institutions in this category believe that a shift of responsibility from their national supervisors, with whom a satisfactory relationship already exists, to an untried pan-European supervisor would make the architecture of supervision more cumbersome with few incremental benefits. Furthermore, many issues would be opened with the creation of a pan European safety net that would take responsibility for the institution's positions in Europe while excluding those elsewhere.

There is wide agreement that the existing distribution of national and supranational authority against has some shortcomings. However, so long as those arrangements are viewed as satisfactory, and so long as national authorities are seen as having the means to exercise ongoing supervision and to manage potential or actual crises, there will be hesitation to change the system. In this context, there are many analysts and officials who believe that, despite admitted ambiguities on some points, present structures for supervision have served the EU financial system reasonably well.

Defenders of the present system believe that there is a strong case for preserving the main elements of this system, even as efforts are made to correct certain shortcomings. It is observed that present supervisory mechanisms have allowed domestic financial markets to develop over the last 20-30 years and for European financial integration to progress despite crises and episodes of instability. While it is true that there may be differences in viewpoints of home and host supervisors in applying supervisory principles under normal conditions, these are the kind of issues that are best resolved by

reinforcing existing mechanisms for the coordination of financial supervision, notably the Lamfalussy process.

One effect of the present architecture has been to encourage a degree of healthy competition among national supervisory frameworks that has tended to lead to ongoing improvements in supervision with a good mix of market integrity and flexibility. Before the advent of competition among markets and supervisors, national authorities often overregulated their markets and tended to stifle the development of new financial techniques and services. Competition between markets and supervisors has been an important factor in producing a dynamic and integrated financial market in Europe while lessening regulatory rigidity. It is true that supervision is far more flexible and the risk of overregulation is much less today than two or three decades in the past. Nevertheless, it is credible that consolidation of authority in a single EU supervisor would lessen regulatory competition in Europe.

A final explanation of the reluctance to introduce basic change is that anyone proposing to change the system must not simply point out inadequacies in the present regime, but must also suggest how an alternative system should be structured. For example, it was pointed out that despite some trend toward unified supervisors, there are many countries that prefer some other arrangements for financial supervision, with France and the Netherlands being cases in point. Different views are also found concerning the appropriate role of the central bank in financial supervision.

It was argued that the two main arguments in favor of a change n the supervisory architecture are 1) that present arrangements are inefficient at times when the market is functioning normally and 2) that the system may heighten systemic risks in time of crisis. After a long period in which many policy makers were starting to conclude that the supervisory model had finally succeeded in practically eliminating systemic instability, the market turbulence that began in the summer of 2007 has re-animated the debate about the adequacy of the present system in times of systemic strain. One the one hand, defenders of the present regime argued that during and after the summer of 2007, national supervisors, national central banks and the ECB faced a fairly serious episode of instability with systemic implications and made major decisions to provide liquidity and/or to support various institutions or to resolve institutions with poor prospects. Thus

some concluded that the present system is sufficiently flexible to deal with rather serious episodes of systemic strain.

On the other hand, there are those who believe that the crisis has revealed unacceptable levels of fragility in the system. Those holding this view retort that 1) none of the institutions that became insolvent since mid-2007 fit the definition of a pan-European institution of systemic consequence and 2) the crisis did reveal some strains closely related to the fragmentation of supervision. In this context ECB President Trichet intimated that his institution had to act without sufficient information on the situation of banks in member states, suggesting that the ECB may have been obliged to err on the side of overexpansion due to paucity of information. In a similar vein, Italian Finance Minister Tommaso Padoa-Schioppa also said that the ECB was required to act in an environment of insufficient information. He drew a contrast between the ECB, which was able to take decisions and act in the common interest while European supervisors did not share necessary confidential information, did not have a common analysis of the crisis and did not meet to make decisions.

The difficulties encountered in 2007 were judged to be serious enough to warrant a fairly sizable reemission on the supervisory architecture. Padoa-Schioppa proposed a single European rulebook based upon enhanced powers under the Lamfalussy framework and 2) integrated supervision of pan-European institutions using a college of supervisors and a lead supervisor regime. At the same time, he stated that the vulnerabilities exposed by the post 2007 crisis could be addressed with evolutionary changes the existing legal framework, rather than through a full scale overhaul of the supervisory architecture. (Padoa-Schioppa 2007 a and b.)

To the degree that proposals to have EU-level supervision are linked to basic changes in institutional arrangements for supervision, the risk of stirring resistance in several countries rises. Anyone proposing sweeping changes in current arrangements must also indicate how the new system would address other problems such as the lack of integration in retail finance. The more one attempts to address such issues in a comprehensive reform package the more one is likely to encounter the resistance of national authorities that prefer institutional arrangements for supervision that deviate from those in the proposed model

Synthesis: Defining a Workable Project for Reform

Earlier sections of this paper described the historical origins of Europe's current present pattern of financial integration and financial supervision, which divides supervisory authority between national and supranational levels. Subsequently, the paper summarized some of the anomalies that have arisen because financial institutions operate in an international environment while the legal and supervisory framework in which they operate remains national. A variety of suggested reforms was reviewed. In the preceding section some reasons were suggested as to why, despite the divergence between the financial market and financial supervision, many interested parties and many analysts are hesitant about introducing major adjustments to the system.

This section puts forth some concrete proposals for reform, borrowing many elements from proposals that have already been made. In proposing reforms one could take two broad approaches: 1) to construct a comprehensive system that resolves all possible problems in the current system and constructs the best system imaginable, regardless of its chances of actually being implemented, or 2) to propose a system that removes the most egregious flaws in the present system and has the best chance of being enacted. This paper takes the latter approach by proposing ways in which the most glaring shortcomings of the system may be addressed while disturbing the present balance between national and EU authority only as much as is necessary. This approach is most consistent with a process of encouraging evolutionary change in the system and thus might have a better possibility of gathering broad support.

This proposal would focus on the medium term. It would make it possible for the European financial system to adapt gradually to changing market conditions while allowing the system to progress to its next phase of evolution. At a later time, perhaps in about one decade when the contours of the financial market have evolved further, other modifications to the system can be considered.

The core of the proposal is to create an EU banking license that allows all institutions to choose between national and EU supervision. Institutions choosing national licenses

would be supervised as before.[3] Those choosing the EU license would accept a supervisory regime based upon:

1. The lead supervisor concept;
2. An ESFS structure for decision making; and
3. An EU banking safety net consisting of a) an EU wide regime of deposit regime b) a decision making structure for the resolution of troubled institutions and c) a related funding mechanism.

Until now, this paper has used the expressions “bank” and “institution” more or less interchangeably in recognition of the fact that financial institutions now conduct commercial banking, securities, and frequently insurance inside the same group. However, the supervisory reform being proposed is essentially aimed at banks and at bank supervisors rather than at other financial institutions and their supervisors.

Most of the issues related to overlapping jurisdictions and to the use of risk management and capital models (particularly in the Basel II context) concerns banks rather than other financial institutions. Furthermore, only banks have access to the safety net and the main institutions that have been judged to be of systemic importance and that governments have seen fit to provide with liquidity or to recapitalize are banks. It is true that banks in Europe have long engaged in securities operations and that most securities operations are defined as falling within the sphere of banking under the Second Banking Directive. Furthermore, banks increasingly engage in other operations and the activities of other categories of institutions (securities houses, hedge funds, primary brokers and insurance companies) may affect the financial quality of banks.

Banking supervisors and central bankers will still have to be assured that they have a full picture of the risk profile of banks for which they are responsible. Nevertheless, the ESFS would be primarily concerned with banking supervision. Other activities of banks are of interest to the ESFS only insofar as the effect the prudential soundness of banks and the possible mobilization of the safety net. If the institution responsible for banking supervision in a given country has wider responsibility, that would pose no difficulty.

[3] For a similar proposal, see Čiják and Decressin, 2007.

Such institutions already take part in activities of the CEBS and in Basel-related activities.

Conduct of business regulation (mainly securities market regulation) and consumer protection regulation would continue to be the responsibility of national supervisors. Since these are the kinds of issues (rather than the intricacies of banks' risk management models) that national legislators are most reluctant to yield to a supranational body, this may help to make the proposal more politically acceptable. It is true that there are serious issues of home-host supervisory coordination in the capital markets that raise costs of doing business and encourage regulatory arbitrage. However these are the kinds of issues that are best mitigated through existing efforts to enhance supervisory coordination through the Lamfalussy process.

All banks choosing an EU license would be subject to supervision by the ESFS operating under a federal structure, with an executive board with final decision-making authority and the chairmen of each of the national bodies responsible for banking supervision (See Figure 3). Decisions of the ESFS executive board would be executed by the national supervisor.

Presumably, pan-European banks are likely to find the European license to be most attractive since it will simplify the compliance burdens and align the supervisory structure more closely with the real economic activity of the bank. It might also be desirable for some domestic banks to choose the EU license.

Banks that have large shares of their operations outside the EU will face serious decisions as to whether to remain with their national supervisor or the ESFS. Regular supervision on intra-EU operations will be streamlined as for all other institutions. The national supervisor, acting as part of the ESFS, would assume responsibility for contacts with supervisors outside the EU. The safety net would only apply to operations in the EU; decisions about making the safety net available outside the EU would be based upon whether the operation is necessary to maintain the stability of the EU financial system and whether it is consistent with the principle of minimizing costs to taxpayers in the EU.

Most financial institutions would be supervised by the same agency and most would initially experience minimal changes in supervisory practices. Over time, however, those operating under EU licenses would be subject to somewhat greater pressure to converge toward common standards than those remaining under national supervision. Meanwhile there would be competition between EU and national regulation.

In normal market conditions, the main difference would be that banks would be supervised on a fully consolidated basis, with branches and subsidiaries treated in essentially the same way for supervisory purposes. Host country supervisors would see their capacity to intervene in the supervision of local subsidiaries curtailed, but would obtain representation in decision making via the ESFS.

Banks choosing to operate under an EU license will automatically move from the current safety net to an EU safety net, consisting of a deposit insurance scheme, a mechanism to finance the resolution of failed institutions, and multilateral arrangements for deciding about the provision of liquidity as well as for making long-term decisions as to whether to support or resolve troubled institutions.

All EU banks would subscribe to a government guarantee scheme for bank deposits. Deposits would only be insured up to the minimum amount specified in the EU directive on deposit insurance, currently € 20000. The funding arrangements would follow the proposals of Schoenmaker and Goodhart (2006). In some cases, this would represent a significant reduction in total amounts covered.

Payments for deposit insurance would be notionally made from insurance premiums paid by banks. Also European central banks would contribute a part of their seigneurage into a fund for bank rehabilitation. Any shortfall in the fund, either to reimburse depositors or to support an insolvent institution, would be made up by temporary borrowing by the EU.

Concerning crisis management, banks will be obliged to distance themselves further from their national safety nets and national governments. The discretion of national authorities in using the safety net will narrow considerably. Furthermore, rules governing the use of safety nets will have to be framed so as to diminish the discretion of national

supervisor central banks and treasuries to a minimum. Since the resolution of failed banks will take on a pan-European level, the principle of least cost resolution of banks to EU taxpayers will have to be codified. In this regard, the experience of the Prompt Corrective Action system in the United States in which the law mandates a least cost solution to bank resolution may be relevant.

As with the proposals of Schoenmaker and Goodhart, there remain serious issues concerning the distribution of costs of bank rehabilitation. Since national governments will lose discretionary control of rescue operations, these issues would have to be resolved by common agreement prior to adopting the new system.

The proposed reform outlined in the preceding paragraphs has the following advantages:

It addresses the vulnerabilities of the present system by creating a regime in which supervisory authority is exercised on the same level as actual bank operations, i.e. the pan-European level. However, participation in the system is voluntary and most banks will continue to be supervised as before, i.e. by national supervisors under national regimes.

This approach has the merit of maintaining continuity with present legal and institutional structures. Rather than requiring a full revision of existing rules it provides for a limited modification of rules in well-defined circumstances that leaves most supervisory structures intact. This proposal leaves considerable room for the supervisory system to evolve in line with market developments. In future years, it is possible that most banks in the EU may decide to operate under an EU license or that most may prefer to remain under national regulations. In the meantime both national supervisors and the ESFS will adjust practices to reflect market conditions.

It is possible that in ten years most market participants will see no special advantage to having an EU banking license while national supervisors introduce measures to enhance regulatory flexibility. Conversely, the benefits of EU-wide supervision may prove obvious and most institutions may gravitate toward pan-European rules of supervision. In those cases it will be easier to resolve issues such as unified versus sectoral supervision or the harmonization of consumer protection rules in finance.

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