



The establishment of the European Monetary Union (EMU) has led to differentiation between the institutional frameworks for the monetary policy and financial stability within the eurozone. The monetary policy is decided on at eurozone level, while managing financial stability has remained

primarily national. Furthermore, not all of the EU's countries entrust prudential control to their central banks. Neither was the ECB given any direct remits in terms of control when the Maastricht Treaty was adopted; it has only a consultative role.

This structure is geared to financial activities that were primarily carried out on a national basis and the various supervision practices seen at the end of the 1980s. For their part, the successive EU treaties reflect the commitment to maintaining a European construction founded on the political and budgetary independence of the various States. The "no bail out" rule included in the Maastricht Treaty makes this commitment a reality.

However, despite the various mechanisms that exist for cooperation, this situation is proving to be unsuitable for the supervision of financial groups who operate in several Union countries. Indeed, the advent of the euro, the speed of financial innovation and the emergence of cross-border financial players combined with growing financial integration are accelerating the international spillover of risks.

The integration of supervision at European level is essential for the prevention of difficulties for financial players and their possible systemic consequences.

Eurofi's proposals make it possible for States to keep control over managing the difficulties of financial players operating on their territory, but based on complete information concerning their risks. The proposals involve them in the setting of prudential requirements and provide them with guarantees that any issues that may arise due to a distortion of competition will be managed effectively. This new architecture reduces the needless administrative and prudential constraints, benefiting the pricing of financial services.

These proposals are based on grouping the Union's supervisors together within a network in order to define fully harmonised prudential rules, ensure the convergence of supervision practices and supervise cross-border financial players.

For each cross-border financial institution, such a network-based approach calls for specific colleges to be set up, made up of supervisors with a common and country-neutral mandate.

It also calls beside their transformation required by macro prudential supervision<sup>2</sup>, for a transformation of the European committees currently grouping together on one side the banking and on the other side insurance supervisors, by giving them powers to harmonise rules and practices, arbitrate on disagreements in terms of risks or competition issues, and work at European level to assess the impacts of the colleges' prudential decisions in terms of competition. These committees should be provided with the powers and resources required.

**1. In light of the cross-border development of financial institutions and activities and the acceleration in financial innovation, the supervisors of financial groups' local subsidiaries are no longer able to guarantee a quality level of control**

Today, around 40 European financial players<sup>3</sup> (insurance and banking) have a very significant volume of cross-border activities. At the same time, Europe has a single currency and integrated capital markets, which is accelerating the spillover of difficulties beyond borders, and making the various European economies jointly responsible faced with the cost of a financial crisis.

Despite the existing mechanisms for cooperation, the supervision of these financial groups is still primarily carried out on a national basis. This approach does not make it possible for supervisors from the countries where these groups are based to guarantee quality control over the various subsidiaries and effectively protect their local depositors or insurance policyholders. They are also no longer able to identify the effective risks taken on by these local entities as early as possible.

<sup>1</sup> This Eurofi paper do not engage the Chairmen of Eurofi

<sup>2</sup> See Eurofi paper: "The need and ways to improve macro prudential supervision", [www.eurofi.net](http://www.eurofi.net)  
<sup>3</sup> In his speech on May 9, 2007, Jean-Claude Trichet pointed out that "the mapping exercise for European groups with a significant level of cross-border activity carried out by the ECB shows that these groups, numbering 46 in 2005, had assets that grew by more than 50% between 2001 and 2005, and that they represent almost 70% of all European banking assets! What is more, 16 of these groups hold more than 25% of their assets outside their European country of origin, account for more than one-third of European banking assets and are present in almost half of the EU countries!"

Indeed, these cross-border financial players are characterised by highly integrated and centralised operations from a commercial perspective as well as for their risk and cash management, which makes it necessary for each of the group's supervisors to be able to access the information held only by this group's head office<sup>4</sup>. Moreover, it is at the group's head office that growth strategies are mapped out, future sources of profit are planned, innovations are decided on, and the various corresponding risks are assessed.

It is therefore only at the group's head office that the sources of vulnerability can be detected early on, that the nature of the incentives produced by management control priorities and compensation policies can be assessed, that the quality of management can be evaluated.

The subsidiaries' supervisors are still of course best equipped to supervise the day-to-day handling of operations, notably in terms of operational risks and compliance with national consumer protection provisions. They are also the only ones able to detect local deteriorations in risks linked to the national markets or economic conditions.

Within this context, the financial institutions for their part need to:

- Be covered by an integrated supervision system that makes demands on them in an organized way (number, location and frequency of contacts and reports)
- Benefit from quick decisions in terms of prudential requirements
- Avoid any prudential requirement that is not necessary or may vary from one country to another, that may impact pricing for the products offered and that result in a distortion of competition for domestic or cross-border players.

These groups operate on a global level and should be supervised on a global level, which is not possible for obvious political reasons.

However, Europe must represent an opportunity to provide all of its Member States with relevant information on the financial health of such financial groups and further strengthen cooperation with third-party countries in this area.

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<sup>4</sup> In light of the possibilities opened up by IT and new communication techniques, the industrial and financial optimization of financial institutions is leading them to centralize their capital and cash management, as well as their platforms and administrative and accounting back offices, making only the liquidity required available at local level. Their local offices are sometimes reduced to a simply commercial representation role. Even when these operations are based on subsidiaries, their independence is significantly reduced. Furthermore, the development and the growing complexity of activities are encouraging cross-border financial players to centralize their risk management tools, notably on account of their high implementation costs (IT, human resources). In general, the risk policy is based on various criteria, standards and modeling tools that are defined at central level. Risk portfolio management for financial groups is also globalised, as reflected in the centralized implementation of management systems (securitization, risk exchanges, reinsurance, etc.). After all is said and done, a group's risk profile can now only be understood at central level.

## **2. The integration of supervision regarding prevention functions is accessible**

The Maastricht Treaty's "no bail out" rule is forcing financial institutions' difficulties to be managed on a national basis. This is hindering the integration of supervision, insofar as it is seen as one single process.

And yet, it is necessary to differentiate between the preventative aspect of supervision and the management of a player's difficulties, which require different organisations.

Indeed, the breakdown of stakes between supervisors during difficult times may prove to be radically different since the source and location of the difficulties seen are different from the previous breakdown of risks. Similarly, the burden sharing system determined before the event turns out to be not particularly credible. Lastly, supervisors' operational objectives, common in normal times, may be considerably different during periods when they are managing difficulties: some of them may content themselves with a supervisory role for a local office in bonis, while others may be forced to take part in bailouts.

That is why it is relevant under these conditions to focus efforts to integrate supervision on its prevention functions since it respects the current political autonomy of the Member States. This involves offering, under all circumstances, identical quality information for each one of the supervisors of cross-border financial groups, enabling them to enter into the crisis management phase in an optimum situation.

In order to ensure genuine confidence between supervisors in this supervision work, their exchanges of information should be made compulsory; moreover supervisors within a specific college should have a common European mandate. Similarly, the financing and implementation – in a network as well – of national depositor protection schemes would certainly contribute towards this.

However, as soon as a major default has been confirmed, each supervisor should only be accountable to its national political authorities, which represent the only ones able to consider a budgetary response on account of the Treaty's "no bail out" rule. Unless for instance setting up dedicated European contribution rules or a supranational budget for this type of intervention is possible. In other words, the integration of the handling of a financial player's difficulties is conceivable provided that it is preceded by a financial solidarity agreement for States and their taxpayers in order to help out financial institutions whereas they might not necessarily operate in their country.

In that respect, certain industry players believe that a European approach for cases when financial groups in difficulty go into receivership would make it possible to reduce the corresponding financial burden for the financial institutions or States. The American FDIC has been put forward as an example on this aspect.

### 3. The characteristics of integrated supervision and the conditions for its deployment

To achieve these ambitions, the European integration of supervision must, on a preventative level, whatever form is selected for its implementation:

- Be based on harmonized accounting and prudential rules
- Ensure that the supervisors of a given group are put in a situation enabling effective cooperation, i.e. that they give access to all to the relevant information in a timely manner
- Have mandates, mechanisms and procedures for cooperation that enable decisions to be taken as quickly as possible, that do not favour any country over another or any financial institution over another, whatever their business models, and that involve countries based on what is effectively at stake for them in the decisions to be taken
- Have neutral appeal procedures in the event of any disagreement between supervisors or appeals by a financial institution
- Use and develop the technical capabilities of the various supervisors, as well as their knowledge of the national economic and regulatory conditions (local conduct of business, consumers protection provisions etc.)

### 4. The founding principles for European supervisors to operate based on a network

Following on from its report published in 2008 on the integration of supervision for cross-border financial groups and the consequences of the insolvency of several cross-border players over the last few months, Eurofi would like to remind readers that the deployment of effectively integrated European supervision requires a prior political agreement, at European level, on a set of principles. These must make it possible to deliver responses to the legitimate demands of both Member States and financial institutions, as set out above. These principles could be as follows:

- European supervisors implement prudential and accounting legislation that is fully harmonized, i.e. transposed in a consistent way by the 27 Member States – definition of capital, liquidity, recognition of assets in the banking book, etc.;
- Since the supervisor for the parent company or European consolidation entity ("group supervisor") has, as a result, an overview of the group's solvency and liquidity, covering major economic and political issues, it is responsible for proposing suitable prudential requirements to the members of the group's college both at group level and for each one of its European offices. These are set unanimously. Otherwise, see Point 6. In this purpose, the group supervisor is responsible for setting up the college grouping the financial institution's various national supervisors together. The group supervisor chairs this college, which also represents the coordinating body for the various supervisors. For

groups that are headquartered in eurozone countries, the systematic presence of a representative from the ESCB as an observer seems relevant insofar as the ECB is the lender of last resort.

- The group supervisor is required by law to systematically ensure timely access to the information required for the other national supervisors, particularly when the group's local activity is significant for the financial markets placed under their responsibility; the information provided must enable them to determine the solvency and more generally the risk profile of the institutions – subsidiary or branch - operating on their national territory, as well as for the financial group as a whole.
- Supervisors within a specific college must have a common European mandate. This means that decisions by colleges must be conceived in the interest of the European clients and suppliers of the whole group. This mandate must include an obligation for timely information for the various authorities involved in seeking financial stability, whether they are national (ministries of finance, national central banks, etc.) or European (ECB, ECOFIN Council, macroprudential supervisory institution, etc.). This common mandate becomes national again in the event of any player becoming insolvent as soon as it becomes apparent that a financial player is unable to implement the plan to reestablish its solvency as negotiated with its supervisors.
- Host supervisors must be able to adapt their own control and supervision mechanisms in line with the specific features of each cross-border group in order to enable the group supervisor to include them in a coherent and optimized approach for its control and supervision; furthermore, this would contribute to the gradual convergence of practices at European level.
- If there is not a consensus between supervisors on the assessment of the various risks, or the perception of a local or cross-border financial institution<sup>5</sup> on any possible competitive imbalances, the supervisors must have a means of appeal that is neutral, effective and quick. This would help respond to the concerns of Host States in which many foreign institutions are based or the concerns of financial institutions operating on a domestic basis. In this respect, CEIOPS or CEBS<sup>6</sup> must be able to issue binding decisions taken based on a simple majority.
- CEBS and CEIOPS must regularly review the impacts of the prudential measures adopted by the various colleges in terms of competition and financial stability, the efficiency and effectiveness of the supervision and control practices deployed by the colleges, and lastly, the level of consensus achieved within the colleges; they must report on this to the Union's institutions and must have the resources required to perform these missions.

<sup>5</sup> Through its national supervisor

<sup>6</sup> Beyond the Commission proposal to the European Parliament and the Council dated 23 January 2009 (SEC (2009) 54)

## 5. Others decision-making mechanisms present various disadvantages

Others alternatives in terms of decision-making process linked to the setting of a financial group's prudential requirements are often discussed. Compared with the Eurofi approach they may all appear to have various disadvantages; when the decision-making power may for instance be entrusted to:

- The group supervisor: it has a privileged vision of the group's risks, and more specifically the parent company's risks; however, insofar as it does not have precise knowledge of the local markets' specific characteristics in terms of risk and competition, this option is faced with strong resistance, particularly when setting local prudential requirements.
- The 27 Union supervisors: in addition to this system's complexity, in this case, certain supervisors take part in decisions without actually being stakeholders.
- The college of supervisors with a weighted majority (weighting to be defined): this procedure encourages influence from alliances from one college to another that may pollute, through exogenous elements, the decision on the player's solvency. This procedure is likely to result in conflicts between European supervisors.
- A centralised European body (European agency): it would have to provide guarantees on its ability to effectively assess and manage the local markets' specific features in terms of risk and competition. It will also be required to constantly lead a process to harmonize national supervisors' control practices, as well as a system providing continuous information for national supervision authorities on the health and prudential provisions of cross-border financial players. Indeed, the national supervisors would still be essential for overseeing strictly local players and performing, on behalf of the national political authorities, the preventative or curative operational management of transnational players' difficulties.

The Eurofi framework proposed in this paper introduces a totally different context for supervision. Indeed supervisors gathered in a College share a single and similar mandate and seek the same objectives. In such context the decisions of the college do not consist of balancing different and even competing national interests. On the contrary they consist of checking the accuracy of the financial-group risk profile assessment to the elaboration of which contributed the more relevant supervisors. They also consist of validating the appropriateness of capital and liquidity either group-wide or local requirements. This framework allows a more effective peer approach, limits conflicts and appeals and increases efficiency; its specificities overall explain that the college decisions upon proposals mainly shaped by home supervisors, are set unanimously.

## 6. Remits required

The examinations carried out by Eurofi highlight the need to clarify the conditions for voting within CEBS and CEIOPS. More specifically, a qualified majority would in most cases be inappropriate in terms of ensuring the neutrality required for arbitration. Furthermore, such Committees must have sufficient resources to be able to prepare the arbitrations and analyses requested of them. In this respect, the time they spend drawing up the opinions requested in connection with the European legislative process must be reduced to the essential; in particular stopping systematically looking for a consensus in favour of presenting the various national supervisors positions would make a significant contribution towards this.

These committees must have sufficient powers to ensure the effectively harmonised deployment of European prudential legislation, ensure the convergence of practices, arbitrate on disagreements concerning risks or competition issues, and works at European level to monitor the impacts of the colleges' prudential decisions in terms of competition.

Furthermore, it is essential to involve the teams overseeing the financial groups, with staff that are specialized in the critical analysis of strategic choices, in order to be more responsive when assessing the vulnerabilities brought about by changes in financial businesses. Similarly, it is important for the supervisors to supplement their reporting-based analyses through close contacts with staff from the financial institutions and regular in-depth dialogue with their management board. More generally the proposed framework suggests supervisors teams are equipped with sufficient seniority to appropriately investigate on key management priorities, on business models evolutions and interact with financial group senior management.

## **7. European regulatory and supervisory framework must take the specific features of banks, insurance firms and markets into consideration**

There are major differences between banking activities and insurance activities: primarily non-economic risks and limited use of leverage for insurers, transformation risks in banks and the highly systemic nature of their activities, etc. This points to the need for a supervision structure that recognises these specific features, notably by enabling sufficiently specialised teams to be brought into play on each one of these financial activities. At the same time, the diversification of financial players calls for a sufficient level of coordination between banking and insurance supervisors. This is not only required in order to enable appropriate supervision for financial conglomerates, but also to guarantee that the prudential consequences of the diversification of these players are handled correctly in terms of competition. That is why it is still relevant to separate the activities of the CEBS from those of CEIOPS. But sector analyses should also be systematically shared in terms of changes in businesses, competition conditions, etc.

For its part, the CESR has specific features: it groups together national regulators in charge of regulating and supervising market activities that are subject to national legislation. However, the volume of cross-border transactions carried out on such markets has increased significantly. This represents a source for a cross-border spill-over of risks. That is why the CESR must not only be able to ensure the consistent deployment of European market legislation, but also identify these national sources of risks and eliminate them, particularly since these sources of risk translate in most cases into competitive distortions between the markets. In this way, the CESR should also be given sufficient corresponding powers.