



**Eurofi 2008 -  
Thursday 11/09/08**

**Session [5A] - FOR AN  
EFFECTIVE SUPERVISION  
FOR CROSS-BORDER  
FINANCIAL GROUPS:  
Foundations and content  
for a European agreement**

### The Panel

Moderator: **Jacques de Larosière**, Co-President, Eurofi

Panellists: **Joaquín Almunia**, EU Commissioner for Economic and Monetary Affairs; Pervenche Berès, MEP, Chairwoman, Committee on Economic and Monetary Affairs, European Parliament;

**Baron Alexandre Lamfalussy**;

**Jacques Maire**, Senior Vice-President, Head of European & Public Affairs, AXA Group; Tommaso Padoa-Schioppa, Former Italian Minister of the Economy and Finance;

**Xavier Musca**, Director General of the Treasury, French Ministry for the Economy, Finance and Employment;

### The Debate

The current economic climate was very difficult, and it had not changed in the way that had been hoped, said **Joaquín Almunia**, EU Commissioner for Economic and Monetary Affairs. "A strong and stable financial system is a precondition for a strong and stable economy – that is something we are reminded of every day, particularly since the crisis broke in August last year. In the present circumstances, protecting financial stability is a major priority."

Until quite recently, that responsibility had lain with national supervisors, but this had changed dramatically thanks to the introduction of the euro and other financial integration measures. Of 8,000 banks in the EU, the 14 biggest accounted for almost a third of assets, the Commissioner said. This was a positive development, but as the financial landscape changed, so did the risks and a pan-European and global approach was needed. "This is not a theoretical point – we have been aware of the risks for some time and they are now materialising. What we would have believed barely possible is now probable, and we have not been very well prepared for the worst-case scenario."

How would a problem such as Bear Stearns be managed in the EU, he asked? "I am not sure we have the full answer to that." A great deal of progress had been made, with the introduction of the EMU and the

Lamfalussy process showing that the EU and European institutions could deliver financial integration to the benefit of the stability of the system as a whole. A lot of groundwork had been laid for an increase in supervisory convergence and co-operation, particularly the recent advance in crisis management arrangements that had come from the adoption of the EU-wide MoU that included a set of agreed principles on crisis management and a common framework to address systemic risks.

The Commission welcomed the fact that Level 3 committees would play a greater role in promoting supervisory convergence and assessing risks to financial stability. The creation of colleges of supervisors for cross-border banks and the move to enhance the role of lead supervisors was another important step. The colleges would provide a very useful forum for exchanging information and co-operation among national supervisors. Nonetheless, there was still work to do.

National supervisors answered first and foremost to national taxpayers, so they had to put national interests first, "even if the greater good demanded otherwise". In spite of the introduction of an EU dimension in the mandate of national supervisors, "we must be aware of the conflict that these dual mandates could create".

"These problems are well-known and acknowledged by all parties. Host countries may be reluctant to relinquish some responsibilities in the name of greater efficiency, especially if there is no guarantee that, in the case of failure, the common interest will take into account the economic impact on the host country," Mr Almunia said. The government would have to justify to taxpayers using their money to rescue an institution based outside its borders and so not accountable to local citizens.

Further work was needed on burden-sharing, which had been a consistent theme for the Commission over the last two years. "The progress achieved so far falls well-short of what is needed if there is an imminent threat to financial stability at a cross-border level."

The Commission also welcomed a more ambitious approach to Level 3 committees. "We can only deliver supervisory convergence if we have the relevant authority and necessary tools." Yet proposals to make the Level 3 committees EU agencies had received limited support from member states so "it may be premature to expect a substantive step forward at this stage. I am reluctant to dismiss them entirely, though," he added.

The Lamfalussy group had no mandate to define the architecture of any future supervisory because this was seen as an issue for member states, said Pervenche Bérès, MEP, Chairwoman, Committee on Economic and Monetary Affairs, European Parliament. It had become a very important topic in the last year.

The European Parliament had tried to contribute to the debate, most

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recently with a report on the future of supervision in the EU and it had launched a study on the situation of cross-border groups in the EU. "Even when groups are active in different member states, there are no truly international groups in the EU. Axa, for example, is a cross-border group but there is no doubt where the company is settled and which is its main supervisor." The same applied to Société Générale's problems – it could be seen as cross-border, but the situation was settled by the French authorities. "We have groups with cross-border activities but we do not have 'European' banks or 'European' institutions. All institutions are located in some country."

Having said that, there was still a need to make progress in how these groups were supervised. "The burden of supervision in different countries is contrary to the internal market and the security of the financial markets and it could create real systemic risks," the MEP said.

The Parliament was waiting for the Commission to come out with proposals for legislative initiatives to revise the status of the Level 3 committees. "Co-operation between supervisors will not be enough. The Parliament is asking for a Wise Men & Women group to look at the long-term future of supervision and the issue of deposit guarantee schemes."

Ms Bérès continued: "We are aware of the debate between home and host supervisors. If we want a system that works, we need to respect host supervisors – but someone has to take decisions and that is the home supervisor." Participants in smaller markets who said that this would create a system that favoured larger players were wrong, she added. "It is much better for them to have an EU system than a system of colleges. If they want a system of equality, it needs to be under an EU umbrella – that is why we need to upgrade the EU supervisory system – otherwise it will just be a privilege for bigger groups."

Obstacles had to be overcome in regard to the industry; to regulators and to member states, which is where a 'Wise group' could make a mark. "The obstacles are quite substantial, but the world is not going to wait for us to come up with a solution."

There were numerous arguments in favour of a special supervisory regime for large, cross-border groups, said **Baron Alexandre Lamfalussy**, including the key role the banks and other highly leveraged institutions play in preventing and managing crises.

"There will always be – and there should be – crises, because that is how the market corrects itself in a capitalist world. However, we want to avoid local crises becoming full-blown systemic issues of macro-prudential concern," he said.

Another reason for a particular supervisory regime was the obvious systemic risk associated with the failure of a cross-border bank. Supervision had to help ensure crisis was unlikely and to enable institutions to deal with crisis

that was not of their own making, "which requires a very demanding supervisory performance".

"It is not enough for supervisors to check the existence of effective risk management systems and compliance with those systems, they have to pass judgment on the quality of the systems with reference to evolving business practices and models," the veteran financier said. "This implies that they have real-time information about such developments and are capable of assessing the continued relevance of existing supervisory systems." Few supervisors had voiced concerns about the massive transfer of assets to balance sheet vehicles at a time when banks would have been well-advised to account for the possibility that either legal uncertainty or reputational issues would force them to reintegrate such loans into the balance sheet.

It was possible to foresee a situation where a supervisor did all the right things, looking at a bank in isolation and seeing no cause for concern, but still contributed to a macro-prudential crisis – something Baron Lamfalussy had experience of in the Mexico crisis of 1982. "How do we make relevant such micro-prudential information to assess whether there is a macro-prudential crisis in the making?" he asked. "We should add up the facts and figures relative to individual institutions and see if the aggregate figures raise the spectre of systemic risk." If supervisors noted new practices that needed closer scrutiny, they should inform supervisors of other groups and if the practice was widespread, they should digest the aggregate information and act accordingly.

There were obstacles to the exchange of such information of this type of highly confidential information, both from a legal point of view and because of institutional reluctance to share information. Furthermore, asking supervisors to check systemic risks of new models was something for which they had not been trained and which was alien to their micro-prudential mandate. Even so, the legal obstacles should be lifted and supervisory mandates should explicitly include macro-prudential concerns.

To achieve this, traditional supervision should be bolstered by someone in charge of detecting emerging systemic dangers, who had full access to information about what was happening both within and outside the supervised bank. Banks with a wide range of activities were a precious source of information on issues such as the emergence of new institutions, quasi-banks, changing business models in existing institutions – such as the monoline insurers, and the development of new products and techniques. "Gathering such information would help the authorities get a view of what might happen in future rather than relying solely on analysis of the past," he said.

Given central banks' key role in preventing isolated events developing into systemic crises; their role as privileged recipients of information

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on prospective problems and their familiarity with complex financial instruments, the person should come from a central bank. "For these reasons, I suggested about four years ago that consideration should be given to tasking the ECB with co-responsibility for the 46-47 very large Euroland banks and I would add now that it should focus on early detection of potential systemic developments."

"Would any such action have encouraged central bankers who expressed concern before the crisis to go beyond those repeated expressions of concern and helped to restrain the euphoria that bears the major responsibility for our current predicament?" he asked. "No-one knows the answer to this question but the availability of aggregate information would have given substantial support to the concerns of the ECB. No such information was available at the right time, nor does it exist now."

While insurance was often seen as the financial services laggard in terms of supervision, **Jacques Maire**, Senior Vice-President, Head of European & Public Affairs, AXA Group, told the conference. The hot topic in supervision was Solvency II, the regime that would apply to insurance groups, "which could be taken as a sort of roadshow for preparation on the next steps of Basel II".

There were specific aspects of the insurance industry that allowed it to be in the vanguard of regulatory advances, notably the fact that it did not take uncalculated risks. The industry's risk profile was very different from that of banks, Mr Maire said. "We have liability risk as well as market and asset risk, so diversity of risk does not play the same role."

The nature of insurance risks and liabilities linked to the fact that the sector had "a reversed cycle of cash flows," which meant that during the current liquidity crisis, insurers had been making a positive contribution.

Insurance risks were less correlated to financial markets, so companies were less affected by international economic conditions and if an insurance company failed, there were no direct impacts on the payment system, meaning that one failure did not have a systemic effect in the way that a bank failure could.

Finally, diversity of risks was at the heart of the industry's economic model, which shaped its prudential requirements. "All of these characteristics have been largely recognised by policy makers, making it possible to design a supervisory architecture that can be seen as more ambitious than for other parts of the financial system."

The implementation of Solvency II was a once in a lifetime experience moving the industry from the 19th to the 21st century. One consequence of the change was that the main focus of supervision of cross-border groups would be at the consolidated level. "This is a revolution for supervisors and for the industry," Mr Maire said.

Cross-border supervision was both difficult to accept and to negotiate

because it implied a transfer of sovereignty in terms of rule-setting and prudential requirements. "Group support is at the heart of the compromises that are necessary." The group supervision takes into account the global risk profile of the company and aligns solvency measurement with the company capital and risk management: the consolidated supervision allows recognition of diversification benefits. The group support regime, through a guarantee from the parent company level (the so-called group support), allows a reallocation of these diversification benefits from the group level to the local level. "We have to make a choice – if we want centralised supervision, we have to be able to give guarantees at local level. It is very demanding for supervisors, but also for the industry because even in times of crisis, decisions are made by the group supervisor."

How to combine this with the concept of a level playing field was the main political problem for the implementation of the system, Mr Maire said, and there had been very lively discussions in the European Parliament and the European Council. There were three prerequisites for success.

- 1) Full harmonisation of rules, which would make market players feel more secure
- 2) A split of responsibilities between local and group level
- 3) A level playing field under the governance of the Level 3 committee.

While regulatory arbitrage was difficult at national level, at group level the whole internal market would be affected by such behaviour from supervisors. "We need a guarantee that decisions taken by the group supervisor are fully in line with the interests of the internal market and all EU consumers."

**Tommaso Padoa-Schioppa**, former Italian Minister of the Economy and Finance, said the question was what was needed for effective supervision of cross-border financial groups. There were grand solutions, the most ambitious of which would require changing EU treaties to create an equivalent of the ECB and to shift from a national to an EU level of competence for financial supervision, a radical solution that Deutsche Bank, for example, had come out in favour of. Less ambitious proposals, not requiring changes to the treaty, called for strengthening the authority, resources and legal status of existing committees. There had been repeated proposals, which were implementable if there was unanimity around the table of the EU Council.

"I will suggest something much less ambitious and more concrete," Mr Padoa-Schioppa said. "What are the conditions for a cross-border financial group today?" There could be, say, 10 banks controlled by a holding company, all locally licensed. The group, as a legal entity, is not legislated for at EU level and does not have equivalent legal status in different countries. Although the 10 banks were subject to the same EU directives, the way these directives had to be complied with was stated in national legislation that was translated in widely different ways.

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For example, certain types of asset could be eligible for capital requirements under Basel II in one country but not another. Furthermore, the group was not seen as a group by the different supervisors and the endless discussions on colleges showed that consolidated supervision did not exist. On top of that, no-one was taking account of “the group of groups”, the family of EU cross-border groups. The French authorities might be aware of the cross-border activities of BNP, for example and the Italians aware of what was happening at Unicredit, with German supervisors following the fortunes of Deutsche Bank, but no-one knew about the effect of the three groups’ activities together and how it might contribute to systemic risk.

What was the solution, without recourse to the ambitious solutions already mentioned? “I think we have to impose two requirements.”

First, the same directive should apply in exactly the same way in different countries and secondly, there should be a full pool of information about groups “so the family of EU-level groups is seen by the same eyes just as all national groups are seen at central level”.

This was possible, but the amount of time ministers devoted to the issue was minimal – they relied for their advice on civil servants, who followed the advice of national supervisors, who said that everything was fine and there was no need to change anything. “It is just a question of emancipating policy makers from their condition of captivity,” he concluded.

**Xavier Musca**, Director General of the Treasury, French Ministry for the Economy, Finance and Employment, proposed some more politically acceptable ideas that the French Presidency hoped to propose to the other member states.

The starting point was to look at what was needed to supervise pan-European groups.

- 1) A risk assessment on a group-wide basis – all the risks of all parts of the pan-European banks including the local risks that could affect local economies.
- 2) A supervisory framework that allowed for an efficient division of labour among supervisors – on-site inspections would be better performed by those who spoke the local language, for example, while there should also be permanent off-site data and unified reporting so that everyone had access to the same data.
- 3) Decisions on prudential measures have to be taken at a strategic level concerning the whole institution.
- 4) If one wanted consistent supervision, regardless of the market, there had to be an assessment of how banks were currently being supervised in different markets and this reinforced the need for unified reporting.

“The French Presidency will stress unity and hope to reach agreement on a common interpretation of directives. This is not as ambitious as the unified textbook set out by Mr Padoa-Schioppa, but it is a very important and practical step we can look for,” said Mr Musca. “We need a very strong co-operation between supervisors so we need colleges with precise and clear decision-making processes because they will have to make decisions on strategic issues.”

Maintaining his focus on the politically viable, he added: “We have to build on what is existing. We need co-operation and transparency otherwise we will fail.” The Level 3 committees had to ensure homogenous application of the rules throughout Europe and act as mediators in the event of a conflict in the colleges.

“These are the ideas the French presidency would like to present to its colleagues. These are not the big ideas that some are looking for but our task is to prove we are able to make some progress,” Mr Maire said.

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