



### The crisis highlights the limits of supervision for financial groups on a national basis

The current financial crisis has first of all reminded us about the strong cross-border spillover of risks. Indeed, Europe is not behind this financial crisis. However, it is being affected by its fallout, since its financial institutions have global activities.

This crisis also illustrates the speed of changes and developments in the finance sector, leaving the regulations trailing behind. Indeed, securitization has contributed to the development of a vast and unsupervised parallel banking system that has played a decisive role in the crisis. The inadequate regulatory framework (Basle 1) and its static application by those in charge of prudential supervision have not been able to impede its excesses. More specifically, the current unrest shows how much the "procyclicality" of accounting and prudential rules is accelerating the development of new pockets of risks.

Without a doubt, the financial crisis highlights the limits of "solo" supervision. Since cross-border financial players are characterized by highly integrated and centralized operations from a strategic and commercial perspective, as well as for their risk and cash management, it is at the group's head office that growth strategies are mapped out, future sources of profit are planned, choices are decided on in terms of innovations, and the various corresponding risks are identified. The financial crisis therefore shows that solo supervision no longer enables supervisors in countries where such groups have subsidiaries to guarantee their quality supervision or to effectively protect their depositors.

**The political obstacles to moving forwards on supervision reflect an insufficient level of understanding of the effectiveness of risk assessment models and the conditions for their effective management; they also reflect the concerns generated by the possible negative consequences of a purely national mandate for supervisors**

The hostility of certain Member States in relation to new prudential supervision architectures is linked to several causes that go together:

The risk assessment models developed by groups seem to be arousing mistrust among certain Member States. In addition, these States' fears over leaving it up to the group's supervisor to validate such models illustrate the lack of cooperation and trust between supervisors. In this way, even if the use of internal models is recognized in the CRD, in practice, their implementation in subsidiaries turns out to be problematic leading certain groups to only deploying "standard" approaches on them.

These Member States are afraid of a distortion of competition between domestic companies and the subsidiaries of cross-border groups: such subsidiaries, benefiting from the proprietary rating systems permitted under the CRD, could need to fulfill a lower level of prudential demands than local companies. These fears once again illustrate a lack of buy-in for the effectiveness of risk assessment models.

Certain countries are afraid that in the event of difficulties for a financial group, the assets that would be expected to materialize the group support (insurance) or meet local liquidity requirements (banking) might not be transferred.

The group supervisor seems to be perceived above all as a national supervisor. Indeed, the home and host supervisors do not have a common and extensive group-wide mandate at European level, which is not facilitating any common approach for risks and is not guaranteeing the legitimacy required for integrated supervision.

### Pragmatic proposals for enabling supervision to work effectively and reassure States that are home to cross-border groups

The success of a group approach for supervision hinges on genuine mutual trust and confidence between supervisors. For this:

Systematic and timely access must be given to national supervisors for the information required. In this respect, the colleges represent a suitable way of working.

The EU supervisors for a given institution must have a common mandate, namely offering identical protection for all depositors, wherever they may live within the Union.

Insofar as a financial player's possible difficulties may have systemic repercussions, the mandate for banking supervisors must also include an obligation to provide information to the various authorities involved in seeking financial stability, whether they are national (finance ministries, national central banks, etc.) or European (ECB, ECOFIN Council, etc.).

In the event of a disagreement between supervisors on the assessment of risks or any possible competitive imbalance, the host supervisors must have a means of appealing against a home supervisor decision. In this respect, CEBS must be able to issue opinions that, without being legally binding, are able to resolve such disputes.

Evaluations for risk assessment tools by supervisors must be consistent in order to guarantee conditions for balanced competition between the various players.

There must be mutual understanding of the systemic consequences of changes in financial business-models, as well as those resulting from economic assumptions that influence the strategies of financial institutions, in order to prevent crises more effectively. That is why the EU's supervisors grouped together within the CEBS must carry out these analyses collectively.

### The pitfalls that the CRD revision must steer clear of in terms of supervision

This proposed directive must be sufficiently coherent. More specifically, it must at the same time:

Give the final say to the Home Country Supervisor for such cross-border groups on Pillars 1 and 2 for prudential legislation in order to enable a coherent, responsive and consolidated approach for their supervision.

And give access to information to supervisors in Host States that are home to branches of cross-border groups insofar as they have a genuine systemic dimension.

Failing that, this would leave the door open for a greater fragmentation of supervision, situations of unfair competition or even regulatory arbitrage practices (e.g. transformation of subsidiaries into branches).

After all is said and done, the adoption of such pragmatic and coherent principles would free Member States up from the various and relatively non-consensual regulatory approaches that are often put forward: improving a system that would remain fragmented, transforming the Level 3 committees into European supervision agencies, two tier European supervisory system, single European supervisor, etc.

### Improving crisis prevention through the collective analysis of systemic risks resulting from changing trends for the business models of financial institutions and from the economic assumptions used as a basis for risk assessment models

Both Central Banks and supervisors already have means of identifying and managing new risks.

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To implement them, it is first of all necessary to recognize the monetary policy's fundamental objective to combat inflation in the broadest sense of the term, even when it appears in asset bubbles. From this point of view, the asset inflation seen over the last few years (property, equities, bonds, commodities, etc.) has not been sufficiently taken into consideration by the Central Banks. In other words, the excessive growth in borrowing and low interest rates account for part of the current unrest, and a monetary tightening must be able to be considered, even with inflation that is effectively under control, as soon as rapid growth in borrowing leads to any excessive increase in certain assets.

In addition, supervisors must make full use of the leeway provided for under Pillar 2 of Basle 2, which leaves them free to increase capital requirements when they consider this necessary.

This possibility must be looked into first of all when validating the risk assessment models developed by the banks. At this time, the supervisors must more specifically assess the risk factors taken into account in these models; however, they must also analyze the possible shifts in trends that could affect the economic data underpinning these models.

Furthermore, supervisors must commit to collectively analyzing the possible systemic risks generated by both changing trends for the business models of financial institutions and the economic assumptions factored in for all risk assessment models, whether they are standard, proprietary, implemented by banks or rating agencies. The conditions for this macroprudential supervision must be put in place at European and global levels. As proposed in the Bank for International Settlements' latest annual report, this supervision should give priority to systemic aspects. Lastly, it should pave the way for even closer cooperation between central banks and supervisory bodies, while making it possible to decide on the corrective measures to be implemented.

**Eurofi's proposals drawn up based on the concerns of Host States and domestic institutions do not call the existing institutional balance into question and are adapted to the specific features of banking and insurance**

The deployment of effectively integrated European supervision requires a prior political agreement, at European level, on a set of principles that will make it possible to deliver responses at the same time to all the legitimate demands of both Member States and financial institutions. These coherent principles required for efficient day to day supervision could be as follows:

- 1- European supervisors implement prudential legislation that is harmonised, i.e. transposed on a consistent basis by the 27 Member States;
- 2- The group supervisor<sup>1</sup> has an overview of the financial group's solvency and liquidity; in this respect, it is responsible for setting suitable prudential requirements for both the group and each one of its European sites;
- 3- The group supervisor must 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 assess the solvency and more generally the risk profile of the institutions – subsidiary or branch - operating on their national territory. To this end, the group supervisor is responsible for setting up a college grouping the financial institution's various supervisors together. The group supervisor chairs this college, which also represents the co-ordinating body for the supervisors. Host supervisors remain best equipped for supervising the day-to-day handling of operations, notably in terms of compliance with national consumer protection provisions.

4- Group supervisors must have a common mandate. This mandate must have a European dimension and must set out to achieve identical protection for the interests of all depositors or insurance policyholders in Europe. In this respect, in the event of any difficulties for the group, the group supervisor must more specifically ensure fair support from the financial group to its various European sites. The mandate must include an obligation for timely information for the various authorities involved in seeking financial stability, whether they are national (finance ministries, national central banks, etc.) or European (ECB, ECOFIN Council, etc.).

5- Host supervisors must be able to adapt their own control and oversight mechanisms in view of the specific features of each cross-border group in order to allow the group supervisor to include them in a coherent and optimised approach for supervising the group.

6- In the event of any disagreement on the assessment of risks or any possible competitive imbalance, the host supervisors must have a neutral, effective and rapid means of appealing against a group supervisor decision. 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 must be able to issue opinions that are supposed to be able to resolve such disputes, and, if the group supervisor decides to not apply them, he will need to formalise the reasons for this decision.

7- The impacts of the prudential measures adopted by the various colleges in terms of competition and financial stability, the efficiency of the control and supervision practices deployed by the colleges, and lastly, the level of consensus achieved within the colleges must be reviewed on a regular basis by CEBS and CEIOPS, and they must report on this to the Union's Institutions.

Certain specific risks for the insurance and banking sectors - the underwriting risk for insurance (liability risk) and the transformation risk for banks - do not have any impact on the general supervision architecture and more specifically on this set of principles; they must be specifically monitored within each college.

On banking area however, the specific role of banks in payment systems for large and small amounts and in financing the economy, and their system-based operations require, in the event of a player experiencing difficulties, rapid reactions involving the central banks (role as the last resort lender) in order to prevent systemic impacts. That is why in this area practical responses must be provided on the organisation of co-operation between supervisors and central banks, as well as their respective responsibilities.

As far as insurance is concerned, the proposed set of seven principles facilitate the definition and the operation of group support mechanism which is necessary for policyholders to be able to enjoy the benefits of geographic risk-diversification. This represents a specific feature of insurance risks found out by the economic approach for evaluating risks.

The seven principles are set up for usual day to day supervision operation, not for the event of a financial group going into receivership nor even into winding up procedure. Thought only an integrated European-level approach would be able to minimise the related financial burden for financial institutions or EU member States, one can argue the seven principles contribute to optimising the management of such periods of difficulties (common and country-neutral mandate for college supervisors, information sharing etc.). However, managing such periods also calls for the harmonisation and integration of asset transfers and insolvency laws as is already the case for branches, which are governed by the law for the group's head office. While these points still need to be worked on in terms of European legislation, the deployment of the principles for integrated supervision represents a step that will not put such future work at risk.

<sup>1</sup> The supervisor of the parent company or European consolidation entity