Financial supervision in Europe: issues and prospects

With the integration of European capital markets, cross-border activity is expanding and financial groups are going global. Against this backdrop, the Financial Services Committee (FSC) alerted the ECOFIN Council in May 2006 to the challenges facing Europe in terms of supervision, namely:

- closer supervisory convergence and cooperation
- greater efficiency, particularly when overseeing cross-border financial groups

These challenges reflect differences among Member States of the European Union (EU) in terms of accountability, organisation and supervisory practices. In particular, they reflect the overlay of supervisory and reporting requirements, which pushes up the price of financial products and services for European citizens. And they underscore the friction between the justifiable need expressed by financial groups for an integrated approach to supervision and the statutory accountability of supervisors, which report to their national authorities.

As Charlie McCreevy pointed out in May 2006, companies raise capital on an international basis, investors diversify risk through cross-border investments, and financial institutions adopt a worldwide approach to service their customers. But these economic agents are often hampered by pointless constraints, such as redundant obligations, overlapping verifications, and 'goldplated' regulations.

Further progress is needed as regards the supervision and coordinated management of the risk exposure of multinational firms. And common technical foundations must be laid to analyse and validate the internal models of local and cross-border financial firms. Despite the work done for Basel II and the centralisation of multinationals' financial functions, national supervisors still do not have a shared vision. This lack of vision applies to the challenges involved in centralising the monitoring of risk management or adopting internal models, to the nature and extent of the risks generated by financial groups, and to the ways of responding to those risks on a coordinated, Europe-wide basis.

The situation is compounded by cultural dissimilarities and by historical differences in the duties and organisational structures of national supervisors. These discrepancies do little to foster a truly consistent and integrated network of European supervisors.

Efforts to gradually implement an integrated approach to the supervision of cross-border groups must take into account both the use of internal models for analysing and managing risks and the centralisation of groups' organisational structures. The needs and the main constraints of national supervisors and financial firms must also be considered, namely:

- the regulatory and supervisory rules for financial groups must not clash with the principles governing the operation of internal models or the centralisation of risk management;

- countries in which groups' subsidiaries or branches could represent a systemic risk because of their size must have appropriate information and resources;
- crisis management procedures involving national supervisors, central banks and governments need to be clearly described and must prove their credibility ex ante;
- supervisors must work in a climate of genuine mutual confidence as regards skills, practices, operating methods and resource availability;
- The procedures used to validate internal models must not distort competition among financial firms.

It is therefore advisable:

- to establish a shared vision of the challenges and consequences of centralised risk management, even before examining how regulators can delegate powers and accountabilities. This can be done through a mutual understanding of modelling techniques and of the key components in the mechanisms for implementing them;
- to clearly define, before rationalising reporting formats, the main functions performed by national and cross-border supervisors and the data they require, and, above all, to clarify the methods used for crisis management.

1. Modelling risks and centralising financial functions should lead to more efficient risk management and reduce idle capital

As financial market participants grow and centralise their risk monitoring and management functions, they develop statistical tools to model risks cost-effectively, and deploy those tools consistently throughout their organisations.

International and European regulators are waking up to the fact that these models are useful and to the positive impact of geographic and sector risk diversification[1].

Adopting a regulatory framework based on these models will provide EU Member States with satisfactory market discipline, given that capital and reserves are measured according to actual risk exposure and that the methods used to assess the models are supervisor-approved. This framework will be all the more attractive since it will allow firms to reduce their surplus capital.

Furthermore, this model-based approach should lead to the development of new products, especially in the field of insurance. Model output data on risk types are the building blocks of effective consumer information. This type of protection is a compelling alternative to the current approach, based on placing regulatory limits or bans on risk or requiring firms to build up excessive reserves. The cost of those reserves sharply diminishes the appeal of the products they offer.

For financial groups and their customers, adopting internal models is an issue of major economic importance. It should allow them to reduce their capital and

[1] As evidenced by the adoption of the Capital Requirements Directive

reserves, a portion of which is superfluous – up to 50% of the capital requirement in insurance and 10%[2] in banking.

This surplus capital is hampering companies' capacity for development. In the insurance sector, it puts some firms at a disadvantage relative to some non-European competitors. And even though it attracts higher ratings from credit rating agencies, and hence better terms of financing, idle capital demands a return, the cost of which is passed onto customers. This in turn forces the European financial industry to make major efforts in terms of productivity.

For European market participants and their customers to reap the expected benefits of internal models and centralisation, these mechanisms must be implemented in such a way that groups operate as a single entity in a single European market and are regulated and supervised accordingly.

2. With the globalisation and centralisation of market participants, domestic and European financial authorities are facing new problems with major political and economic implications

As corporate groups bring their management under central control, their subsidiaries are gradually losing their financial self-sufficiency and independence.

Cross-border financial groups are organising their accounting systems and processes and their risk monitoring activities by business line, unconnected to the legal form of their local entities. Moreover, apart from a few joint ventures, these entities are organised as branches or wholly owned subsidiary. Given and received Liabilities are centralised for each business and offset by counterparty. For the most part, cash funds (in the main currencies, viz. the dollar, euro and yen) are pooled and then managed globally, moving from one financial exchange to another depending on time zones.

One result of this centralised organisation is that it is often hard to retrace and independently monitor each entity's risks – so much so that domestic regulatory reporting requirements are often complied with in form rather than in substance. Transactions are so closely interlinked that it is now unthinkable for a group to "abandon" one of its subsidiaries for local economic reasons. Moreover, such an attitude could harm the reputation of the group as a whole.

For banks, this permanent rollover of cash means that any systemic risk they might pose shifts from one financial centre to another. A liquidity problem affecting a subsidiary or branch would actually originate in a liquidity problem affecting the group and all its business locations.

Under these circumstances, and with the exception of some highly specific currencies or the joint ventures mentioned above, the current requirements on capital and, for banks, on liquidity, are only loosely related to local activity.

[2] Eurofi estimates

At the same time, supervisors must maintain a neutral stance when it comes to validating internal models, so that all firms, be they domestic or international, operate in the same competitive conditions.

3. Regulatory and supervisory authorities have very real constraints and needs

The public authorities of EU Member States are answerable to voters and taxpayers for any problems experienced by the local units of financial groups, as well as for the systemic, political and financial consequences of those difficulties. This will always be the case since, even if financial markets are integrated, countries are still independent in terms of budget and fiscal measures.

For this reason, local supervisors have an unshirkable duty of oversight, which must be taken into account proactively when supervising an integrated, centralised group. This entails providing information on its solvency and liquidity and its compliance with rules on using internal models, about the sensitive elements of the cross-border group, even if they are located in another country, and so on.

The local supervisor cannot simply make do with a broad commitment to transparency in the information received from the group or its lead supervisor. To ensure effective cooperation between supervisors, the local authority must first define precisely what it needs. That said, the amount of material information on local business and context – information that only the local supervisor is supposedly able to describe – is often less than is claimed. The local entities of cross-border groups are parts of an overall business and, as such, are operationally and commercially dependent on the rest of the group.

4. Confidence and effective cooperation among EU regulators and supervisors hinges on a common vision of the issues relating to internal risk modelling and the key role played by crisis management mechanisms

When setting regulatory and supervisory rules for cross-border financial groups, the question of a guarantee fund hardly comes into the equation, in view of the size of these firms. For systemic, economic and social reasons, they may be considered "too big to fail". So when it comes to regulating and supervising them, the key issue is the coordinated management of crisis situations. There are three underlying questions:

1. What arrangements have been made to back up the action of supervisors (especially the group-level supervisor), insofar as a crisis situation means they have exhausted their usual possibilities?
2. What operational roles are played by the home-country and host-country finance ministers and the European Central Bank (ECB), and how are they interlinked?
3. On what basis do Member States share the cost of financial support and restructuring?

One prerequisite for a truly integrated European approach to regulating and supervising financial groups is a common, Europe-wide vision, not only of the issues involved in the globalisation and centralisation of these firms and the implementation of risk assessment models but also of the importance of joint crisis prevention and management mechanisms.

5. Five structural factors for successful deployment of internal models and centralised risk management and assessment for cross-border groups in the EU

5.1 The need for a shared approach to the key stakes and techniques involved in modelling

First, regulators and supervisors in the 25 EU Member States need reassurance about the quality of the models used by cross-border groups and about the internal organisational structures that implement them. It is therefore necessary to devise and maintain a common approach to and assessment of modelling techniques and their relevance, as well as of the key elements of the mechanisms themselves, so as to ensure successful deployment. At the same time, regulators and supervisors must agree on the type of inputs and information needed to certify the relevance of the models and mechanisms submitted to them.

This needs to be done before supervisors think about delegating the approval of internal models, a process that could be based on national supervisors being specialising by activity. It is also a first step toward harmonising and standardising financial groups' disclosures, in line with supervisory demands.

5.2 Specify the procedures and organisational principles for preventing and managing crises

A consistent pan-European approach to crisis prevention and management is one of the prerequisites for effective progress towards supervising financial groups on a Europe-wide basis.

Attention is already being paid to the monetary policy implications of injecting liquidity into a group in financial difficulty – a topic covered by a Memorandum of Understanding between Central Banks – and tests are being carried out by the ESCB on solving systemic crises. In addition, it is necessary to establish principles and arrangements for coordinated crisis management, especially during the prevention phase of systemic crises (information transmission, reaction times) and for sharing responsibilities and the financial burden among European authorities in the event of a crisis (i.e. members of ECOFIN and the Economic and Financial Committee, European supervisory committees, the ECB, national central banks).

To ensure that a network of regulators and supervisors will function reliably and consistently, it is necessary to start harmonising the nature, accountabilities, independence and practices of national supervisors. As Eurofi pointed out in its 2002

report: "it is vital that each national regulator and supervisor should have the same powers, instruments and methodologies".

It is also necessary to clarify the legal basis for ensuring ex ante the reliability and quality of the guarantees that governments may issue to the central banks of other crisis-hit countries.

5.3 Establish the conditions for genuine mutual confidence among supervisors

From a practical perspective, alongside this collective approach, it will be necessary to muster the skills and resources needed from each supervisor. This is the only way of ensuring truly consistent implementation of model supervision and inspection missions and, hence, of building mutual trust.

5.4 Clarify the functions to be played by home and host supervisors

Next it is necessary to agree on the functions to be performed by supervisors in both the home and the host countries of cross-border groups, as well as by the group-level (i.e. home) supervisor. These key functions will serve as a basis for determining and standardising the information these supervisors should either collect or disseminate to other supervisors. This will also be the basis for a more accurate definition of the central role expected of the group-level supervisor. Local supervisors' roles should be organised around that of the home supervisor, taking care to avoid overlap. Lastly, as regards cross-border groups, it will probably be necessary to harmonise the legal and regulatory provisions determining the roles and responsibilities of supervisors.

5.5 Ensure that intra-group solvency and liquidity commitments are reliable

The legal, regulatory and technical efficiency of intra-group agreements (liquidity and solvency commitments to supervisors) also has to be analysed. It is necessary to ascertain whether the diversity of European laws on matters such as collateral arrangements, companies, bankruptcy, etc. will actually weaken the arrangements resulting from financial groups' internal risk-assessment models implementation. The practical implications in terms of harmonisation must also be explored.

Unless all these structural success factors are in place, local arrangements (capital requirements, liquidity reporting statements, etc.) will continue to apply to the local entities of cross-border groups.

6. Efforts to encourage cooperation among supervisors are evidence of progress

The work done for Basel II has clearly confirmed two key principles, namely the centralisation of risk analysis and monitoring and the first moves towards the adoption of internal models. Initial measures to address the European expansion of financial groups and their risk assessment and management policies are now being put in place.

Regarding banks, a supervising coordinator[3] has been decided upon for each group, as have the procedures for sharing information and approving internal models for risk assessment and monitoring.

From the point of view of coordination, the formation of **European regulatory and supervisory committees** (CESR, CEIOPS, CEBS) is a step forward. In February 2006, the FSC adopted a series of resolutions to encourage the sharing and convergence of supervisory practices, to improve cooperation among supervisors, and to develop technical procedures for information-sharing, with particular emphasis on cutting supervisory costs.

These factors are important if the following aims are to be achieved at European level:
- move forward with the procedures for approving internal models and with the allocation of capital and liquidity within financial groups
- implement efficiently the principle of a single point of contact
- establish a linkage between local and group-level supervisors (host /home) in terms of collecting and redistributing information
- organise the respective roles and responsibilities of local and group-level supervisors for the conduct of inspections

At a more fundamental level, however, the following factors must also be taken into account:
- The Capital Requirements Directive situates the Pillar II measures at legal entity (i.e. standalone) level, despite the adoption of internal models. As a result, branches and subsidiaries are treated differently, even though the parent group has centralised its management. This adds an extra additional layer of supervisory constraints.
- The validation of internal models is indeed affected by the group-level supervisor, but a consensus is almost obligatory.[4]
- There is little coordination among the three European supervisory and regulatory committees.
- While banking supervisors have a long-standing tradition of cross-border cooperation, the same is not true in the insurance industry. Here, work on Solvency II actually seems to have encouraged excessively individual approaches, to the detriment of cooperation.

These initial advances will be fruitless without political resolve.

The only way to address the true issues underlying the current work on supervision is through a Europe-wide initiative aimed at realising the five critical success factors discussed above, namely adopting a common approach to and assessment of modelling techniques; mustering the resulting skill and resources; deciding jointly on group-level and local-level supervisory functions; and setting up a legal framework to enhance the efficacy of intra-group agreements guaranteeing the solvency and liquidity of subsidiaries and branches.

[3] Capital Requirement Directive
[4] Art. 129 of the Capital Requirements Directive

Before such an initiative can get underway, there needs to be a shared vision of the economic and supervisory benefits achieved by centralising financial groups' business lines and functions and of the expediency of using internal risk models as a basis for supervisory assessment.

7. Momentum is urgently needed

The deadlines for work on enhancing cooperation and determining methods for responsibility-sharing and crisis management are a long way off. The timeframe for setting technical rules on information-sharing is 2007-2008. The draft Solvency II Directive is scheduled for 2007, to be followed by the associated validation and transposition procedures. And the Commission's 2006 Financial Services White Paper foresees a period of five years to meet the following challenges

- clarify and optimise home-host responsibilities as integration accelerates and to deal with potential spill-over effects
- explore delegation of tasks and responsibilities, while ensuring that supervisors have the necessary information and mutual trust
- improve the efficiency of supervision by avoiding duplicative reporting and information requirements
- [achieve] more consistent and timely cooperation and [..] develop a real pan-EU supervisory culture

Meanwhile, if it were to emerge that the cross-border activities of financial firms engender specific risk, that risk would already be well and truly present. First, cross-border loans already account for nearly 30% of total interbank lending[5]. Second, 40% of bank assets in EU accession countries [6] are held by banks in other EU countries. Last, the 15 largest European insurance companies do 50% of their business [7] outside their home country.

8. Proposal

To build a shared vision and realise the five success factors, it is vital to put momentum behind a political initiative. This does not mean creating new organisations from scratch but relying on the members of the European regulatory and supervisory committees set up under the Lamfalussy arrangements (CEBS, CEIOPS), on the European System of Central Banks, on the Financial Services Committee, and on a small number of senior managers of domestic and multinational financial groups. To that end, the ECOFIN Council should give these people an intuitu personae task with specific goals and a short deadline. The Commission and the Parliament would be closely involved with this Mission.

[5] Papademos, Lucas (2005), Banking Supervision and Financial Supervision in Europe'
[6] Estimates based on European Central Bank data
[7] Estimates taken from ELEC - Financial Supervision in Europe – February 2006

The chief priorities for the Mission in the area of risk management and consumer protection are to identify opportunities for using internal models for regulators and supervisors, to identify the benefits of an integrated approach, and then to work out the conditions for an effective pan-European approach. The presence of managers of insurance and bancassurance companies is absolutely vital in this respect.

Another area of concern is the case of multinational banking groups that could create systemic risks if they run into difficulty, thus demanding a swift response (unlike insurance groups, where the only danger is a solvency risk). On this point, the Mission must develop a consistent pan-European approach for preventing and managing crises.
This involves defining the key priorities and the arrangements for coordinated management (i.e. ensuring that supervisors provide national central banks and the ECB with relevant information as quickly as possible, given their numerous links with Member States), identifying the consequences in terms of responsibility-sharing between stakeholders, establishing principles and procedures for sharing financial support and restructuring costs, and establishing legal procedures for formalising countries' commitments to the national central banks concerned.

One of the results of this Mission should be to clarify and unify the views of insurance regulators and supervisors in connection with Solvency II. At present, the insurance industry is still using the concept of "solo plus" supervision, focusing on supervision at legal entity level ("solo") and affording only partial importance to the group level ("plus"). And because insurance regulation in Europe is highly fragmented, capital charges in this industry are much higher than in banking.

The implementation of Solvency II offers a unique opportunity to:
- provide hitherto prohibited responses to insurance-related needs (however, responses can be found outside Europe, particularly since these needs arise since public solidarity mechanisms are increasingly backed up by mechanisms developed by insurers);
- ensure an appropriate level of cover for different types of risk;
- optimise the cost of capital/product protection trade-off, to the customer's advantage;
- replace regulations with precise information about risk, where appropriate;
- authorise Europe-wide distribution of products based on internal models for risk analysis and management.

One of the Mission's other priorities could be to determine what legal resources CEBS would need to gradually unite the network of banking supervisors in Europe. The work already underway and the initiatives taken by CEBS are laying the groundwork. Political resolve is needed to go beyond not only the legal constraints and accountabilities but also cultural hesitations, which are totally understandable. The result will be a supervisory framework that is totally efficient, both for supervisors and for the firms they oversee.

Lastly, the Mission could examine whether a united network of supervisors is relevant and how it could be implemented. In particular, it could examine the powers that need to be delegated to achieve united supervision and the procedures that should be

used to validate internal risk management models at European level, both for local and for international financial groups, while avoiding a two-tier organisation that depends on whether the group is a cross-border player. These procedures are vital to ensuring a level playing field among market participants.

Having initiated an in-depth debate between institutions and financial firms at the Conference on Retail Financial Services in Europe, Eurofi will endeavour in the weeks ahead to determine establish an appropriate mandate and organisational structure for such a Mission.

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