

Speeding up integration of prudential regulation and supervision of cross-border financial groups

Eurofi's proposals to effectively take into account the needs of financial institutions, member states and their supervisors

This note focuses solely on prudential regulation and supervision of institutions and not on the regulation of markets and products. Indeed, market places in Europe are in competition in markets activities that are nowadays global and this makes harmonisation of their regulation more difficult. Wide variation in consumer behaviour and in consumer protection legislation also makes harmonisation of national legislation regarding products and services much more complicated. On the other hand, financial stability, in a context in which players have become globalised, is certainly a subject of general interest for member states. It can assist in avoiding financial difficulties for the players, in increasing cooperation between national authorities, in reducing the cost of any catastrophes that might arise and in optimising pricing of financial services.

1. Rapidly increasing internationalisation of financial activities requires integration at European level of prudential regulation and supervision of cross border financial players.

- Several tens of European financial market players (in insurance and banking)¹ now have a very significant level of cross-border activities.
- The characteristic feature of these players is that their functioning is closely integrated and centralised, both from a commercial point of view and in relation with risk and to funds¹.
- In each national market of the EU, domestic and multinational institutions are in competition: prudential regulation and supervisory practices must not be responsible for unfair competition.
- Supervision of a cross-border group must be supported by a fully-integrated, global view of liquidity, solvency and the risks taken by that group, so that such supervision can:
 - ensure that the conditions required for financial stability are put in place,
 - be efficient without having any undesirable effects on pricing of financial services are in place

Ideally, these groups, which are able to facilitate cross border spill over of risks, ought to be regulated and supervised on a worldwide basis. For obvious political reasons, that is not possible. Europe, on the other hand, ought to demonstrate its ability to adapt its prudential regulation and supervision to these requirements, since today they are still too fragmented on a national basis.

¹ In his speech of 9 May 2007 at the CEBS conference in London, Jean-Claude Trichet pointed out that "the mapping exercise of European groups with a significant level of cross-border activity carried out by the ECB shows that these groups, numbering 46 in 2005, have assets growing by more than 50% between 2001 and 2005 and that they represent almost 70% of the totality of 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 countries of the EU!"

¹ As a result of the centralisation of management of the groups, subsidiary companies are progressively ceasing to be fully independent or autonomous financial entities. Cross-border financial groups organise their accounting, processing and monitoring of risks, activity-by-activity, without any link with the judicial forms prevailing in their location. In any case, aside from a limited number of "joint-ventures", these establishments adopt the form of branches or wholly-owned subsidiaries. Undertakings given or received are centralised in terms of activities paid for in exchange; essentially liquid funds (in the main currencies: dollar, euro, yen) are brought together then managed on a worldwide basis, moving from one financial centre to another depending on time-zones. Such centralised organisation means that it is often difficult to track the risks in a local basis.

That would make it possible to conduct an overall survey to assess the real risks for each cross border group and would avoid the present superimposing of prudential requirements that is affecting the prices of financial services offered to European citizens, thereby impairing the competitiveness of these players.

The carrying out of the necessary work that is being done by the EU's Economic and Financial Committee on the management of systemic risks (burden sharing, systems for guaranteeing deposits and insured parties, cross-border circulation of assets, developments in the law governing insolvency of financial establishments, etc.) must not under any circumstances should not be an excuse to delay the integration of supervision. This is a key element in risk prevention and in improving the economic efficiency of Europe and its financial operators.

This is all the more the case given that a favourable climate is emerging among regulators, supervisors and European Institutions for establishing specific cooperation arrangements between national supervisors that are based on a fully harmonised body of appropriate regulations .

In addition, the current financial crisis underlines the need to strengthen confidence between financial operators and between supervisors. This call for full consistency in prudential and liquidity legislations and in supervisor's practices in the EU those are currently very diverse.

2. Doing away with the fragmentation in prudential regulation that is itself made worse by the diverse ways in which European laws are implemented at national level.

It is essential to do away with the national options that are allowed by European prudential regulations: despite the international agreement achieved by the Basle Committee, the "Capital Requirements Directive" (CRD), adopted in 2006, contains 101 options available to national legislators. Indeed, these differences unbalance the conditions for competition and prevent unification of reporting procedures requested from cross-border groups. These problems add to those created by unjustified prudential requirements that have been added on by national supervisors.

Doing away with the add-ons and national options requires either a European regulation or a full harmonisation directive to be included in the revision of the "Capital Requirements Directive" that the Commission has to put forward at the beginning of the second semester of 2008.

In addition, European institutions must aim at incorporating, at legislative level and in line with self-imposed timetables, the lessons learnt from the present financial crisis in terms of prudential regulation:

1. Refining common prudential requirements (stress testing and emergency plans to solidify liquidity for financial groups, introduced by the CRD)
2. A European approach that facilitate the rapid integration of financial innovations in the standard approach and in the internal models for evaluation of risks (a mechanism for effective implementation of Pillar II of the CRD and of Solvency II)
3. A unified European or global standpoint regarding balance sheet assessment methods especially in liquidity crisis periods (mark to market versus mark to model)

This European corpus of regulations will nevertheless have to take account of the differences in scale of financial institutions which, in fact, have often been the explanation for a certain number of local regulatory features.

3. How to bring about effective integration of supervision of financial institutions

We are often reminded of the need to integrate, at European level, the supervision of cross-border groups. This is indispensable in order to:

- allow these cross-border groups to take advantage of any benefits that might arise from geographical diversification of risks, as was intended by the work currently under way on Solvency II.
- reduce the cost of prudential requirements, particularly by avoiding the local “add-ons” and their impact on prices passed on to customers.
- ensure that each national supervisor has access to information that allows effective and appropriate assessment of the risks borne by the group as a whole and the possible consequences of such risks for their local branches or subsidiaries.
- ensure convergence in supervisory practices and build mutual confidence between member states seriously and adversely affected by the financial crisis of summer 2007.

In general terms, integration of supervision of multinational financial groups is considered as the keystone in preventing cross-border spill over of systemic crises. Such integration would minimise the cost to the member states and the EU’s taxpayers in the event of financial difficulties being experienced by one of these operators. A large number of entities are in agreement about the need for this. However, there is still some disagreement about the kind of organisation that needs to be set up.

3.1. The solutions that are currently under discussion do not offer a satisfactory answer

There are two models that are most frequently suggested:

- The cooperative and consensual model implemented for example within the various “colleges” of the CEBS at the time of the Europe-wide implementation of Basle II.
- There is also the “lead supervisor” model put forward by the “European Financial Round table” (EFR), which, within a college of supervisors, concentrates authority in the hands of the home supervisor.

At this stage, neither of the two models provides a satisfactory answer to all the requirements that the intended organisation would have to feature.

- a. The cooperative model** does not make it possible to move rapidly towards a meaningful reduction of national prudential additional requirements or a reduction of the administrative burden of reporting or the diffusion of appropriate information to each supervisor (consolidated view of risks). Neither does it favour the rapid convergence in practices nor the consolidation of mutual confidence between supervisors. More generally, this model, which is based on the goodwill of everyone involved, would be implemented under circumstances that would be legally fragile, given that the decisions taken by the colleges have no European or national legislative basis, no power to compel, and are not accountable to either national legislation or to the statutes and powers of national supervisors.
- b. The “lead supervisor” model** assisted by a college of national supervisors is a suggestion frequently put forward by representatives of the profession. However, this solution, as it stands, is opposed by certain people because it does not offer to host member states sufficient powers of opposition in case of need. Moreover the various lead supervisors will continue to behave in distinctly different ways towards financial institutions that are in direct competition. On that basis, this model also risks triggering “supervisory shopping around” behaviour and does not favour the emergence of a genuinely level playing field between EU countries.

Finally, this model raises questions about the size of national deposit or policyholders guarantee schemes in countries that are entrusted with the responsibility of lead supervisors (UK, France, Germany, Spain, Italy, Belgium, and the Netherlands) and their financing by the purely domestic financial institutions of these countries. The latter could

refuse to contribute to funds that might be used to compensate customers in other countries in the EU.

3.2 Proposals: towards effective strengthening of the colleges and level 3 committees

A European supervisory system on the model, for example, of the European System of Central Banks has been suggested. It would probably make it possible to overcome these difficulties. However, given the political obstacles that would have to be overcome for such a plan, it is necessary, come what may, to strengthen the powers of the level 3 Lamfalussy committees in a targeted fashion, to reorganise the colleges of supervisors and, as regards supervision of cross-border groups, to give a mandate that would be no longer national but European to the national supervisors who are members of their colleges. For this purpose, the following principles might be more particularly examined:

1. In order to ensure that the college would work efficiently, the various European supervisors for each cross-border group, whatever their country of origin, would have to receive an explicit mandate to assess local supervisory issues with a Group wide perspective. This requires:
 - priority to be given to defending group stakeholders (creditors...) interests before national ones
 - assessment of the solvency and liquidity of the financial group as a whole and not that of their national establishments
 - provision of information regarding the solvency and the liquidity of the group to the various national authorities
 - matching control methods to the specific features of each group in such a way that the national supervisors would be able to go beyond their current divergent practices.

The efficiency of the provision would also be facilitated once all the supervisors were given the same status and powers.

2. Decisions would have to become binding. Instead of decision-making processes based on either home supervisor authority or simple majority vote (one person, one vote) It would be appropriate to look at the possibility of weighting the vote of each supervisor in proportion to the risks booked in their country and to the volume of their deposits³. A "Board" of supervisors would thus be created for each cross-border group: this arrangement would go well beyond the idea of a mere college.
3. The members of each college would have to reach agreement together concerning the practical measures to be used for supervision and monitoring. This mutual commitment could be formalised by means of a supervision protocol. This would additionally specify the roles and responsibilities of each supervisor for the provision of such practical measures. The way that supervision and monitoring is organised will have to put an end to all duplication of tasks by the supervisors: in particular, such organisation will have to specify, with the group concerned, the points of contact appropriate for them.
4. These organisational principles would have to apply to operations carried out in countries representing a significant level of activity or in countries where the group has establishments that are of major importance within the system.
5. The surplus own funds arising from the diversification of the groups must be eligible to circulate across borders freely within the group in order to guarantee effective support for the group in the event of local difficulties. Moreover, the legal reality, at least at European

³ Each EU country where a cross border group is systemically important, also benefits from the possibility to resort to the arbitration powers of level 3 committees (see point 6 below)

level, of financial commitments between the parent company and its subsidiaries (intragroup guarantees) must be protected at the legislative level².

6. CEBS and CEIOPS must be strengthened by giving them the task of harmonising supervisory practices and guaranteeing a level playing field. It is also essential to give them power to make decisions as a point of recourse either where disagreements have arisen between supervisors or by an appeal open to the group being supervised.

These specific roles for CEBS and CEIOPS ought therefore to be provided with the necessary legal basis and appropriate human, technical and financial resources. Such developments could in fact amount to them being a forerunner of a true “European supervisory system” that could some day, should these arrangements prove to be inadequate, have a specific institutional content.

The process of defining the provisions required for integrated supervision must be managed independently of the organisation of “burden sharing” which will require, whatever happens, specific responses defined on a case-by-case basis as a function of the actual difficulties encountered by a financial group. However, it is important to stress that the organisational principles for integrated supervision presented above ought to facilitate crisis management. Indeed,

- Member states likely to be last-resort lenders for cross-border groups will, in effect, be involved in the supervision of these groups, which should also facilitate the necessary free circulation of assets in the event of difficulties
- These principles also make it possible to envisage deposit or policy holder guarantee schemes working as a network. Working in this way is a precondition for ensuring that the cost of their implementation is fairly shared out (in proportion to the volume of deposits...) between the various financial communities of the countries concerned.

4. A Process should be defined to make quick and significant progress on prudential financial-group supervision.

A process should be specified in order to identify host countries key needs (information, decision making process, arbitrage of litigations ...) and institutional impediments that hinder unification of prudential regulations and achieving effective integration of the prudential supervision of financial cross border financial groups.

Integration of supervision requires a major political effort. Consequently, on the lines of the Delors Committee for setting up the Economic and Monetary Union, a possible tool could be an ad hoc committee set up to reach consensus views on new realistic solutions on these issues. It would be made up of recognized personalities known to be free of any kind of vested interest.

Its members should be appointed as a function of their abilities and also on an “intuitu personae” basis, in order to ensure their independence with regard to the national commitments that they may be otherwise fulfilling. The secretariat for the committee would be organised in such a way as to facilitate the emergence of ambitious proposals and a consensus on the approaches required to achieve truly integrated EU financial regulation and supervision.

Eurofi contacts :

Jean-Marie Andrès, senior fellow consultant: andres-adsconseil@wanadoo.fr

Didier Cahen, Secretary General of Eurofi: cahen.didier@wanadoo.fr

² Some adaptations to national legislations are required to avoid intra group asset transfers to possibly be invalidated by national winding up legislations.