

European Shadow Financial Regulatory Committee

REFORMING BANKING SUPERVISION IN EUROPE

Statement No. 23

Frankfurt am Main, 21 November 2005

In this statement on “Reforming Banking Supervision in Europe” the European Shadow Financial Regulatory Committee (ESFRC) expresses serious doubts as to the adequacy of the current regulatory framework for banking supervision in Europe and makes the following recommendations:

- Formal procedures should be developed and used to determine the scope and the limits of discretionary decisions. In this context, we advocate the creation of an independent “European Banking Oversight Board” to monitor the behaviour of national bank supervisors. This would help to address effectively recent events such as in Italy where there seems to have been discriminatory discretion when a large Dutch bank attempted to acquire an Italian bank.
- A system of prompt corrective action (PCA) needs to be put in place as part of the supervisory process in each individual Member State. PCA denotes an approach in which certain values of indicators of the financial situation of a bank trigger predetermined supervisory measures. PCA procedures would reduce the likelihood of a sudden banking crisis and contribute to host country supervisors’ trust in home country supervisors.
- A European Standing Committee for Crisis Management should be created to alleviate shortcomings of the present system where national authorities from the 25 EU Member States meet in a multiplicity of regulatory and supervisory committees, often with overlapping responsibilities.

1. The adequacy of a decentralised approach

European financial integration is advancing and a number of major cross border actors have emerged. This accentuates the search for a framework of regulation, supervision and crisis management best suited to achieve the objective of an efficient banking sector. Banks should be able to exploit economies of scale and scope without creating instability in the financial sector.

In a statement by the ESFRC in October 1998 we argued that “the twin principles of home country supervision and mutual recognition should be supplemented by a clear allocation of responsibilities in times of crisis and a mechanism to ensure that all financial institutions operating in Europe have an effective lead supervisory authority”. We now return to this argument in the light of recent experience.

Cooperation between national supervisors, combined with a major extension of the regulatory framework, appears to have worked well, in the sense that no major tensions have been observed. The so-called Lamfalussy Process, initially developed for securities markets, has been extended to apply to banks and insurance companies as well and it has had some success in bridging the gap between the needs for common European rules for financial activities and the somewhat different

national supervisory activities and practices. However, we would like to see this overly complicated structure simplified, perhaps merging first and second level committees, but we do not elaborate on this issue in this statement.

In spite of progress made, we have serious doubts as to the adequacy of the current framework in three respects. First, there are signs that the degree of discretion left to national supervisors may be excessive. Second, the commitment to home country control in banking supervision may not fully take into account the recent phenomena that several EU countries today host foreign affiliates that make up a major part of the host country banking system. Special efforts need to be developed to ensure a high degree of trust in the practice of home country supervision. Third, it is not obvious to us that the arrangements made with respect to cooperation in financial crisis situations are adequate to the growing challenges. In the rest of this statement we develop possible remedies to these three problems.

In the present situation, we do not currently believe that consolidating supervisory authority at the EU level would be productive. The political mood in Europe is not favourable to centralisation of authority in new areas, and anyway the process of combining advances in EU regulations home country control and cooperation between national supervisors may for the time being have sufficient momentum. Our proposals also go less far than the request from some of the largest cross border institutions to have a sole supervisor for all bank affiliates, whether branches or subsidiaries.

2. Monitoring supervision and limiting discretion

There are strong economic reasons to leave supervisory competences at the national level. These include the proximity of supervisors to the respective markets, and probably more important, the fact that the possible financial burdens of inadequate supervision would fall on national institutions, such as a deposit insurance fund, or – in the extreme case of a bailout – even on the national finance ministry and, thus, on the taxpayers. Even though there are merits to decentralisation of supervisory powers, there are of course risks involved. Most notably, there is the risk that national competence opens the door for discriminatory discretion, as it seems recently to have been the case in Italy where a large Dutch bank attempted to acquire an Italian bank.

Any recommendation to improve the organisation of banking supervision in Europe must try to safeguard the strengths and mitigate the dangers of decentralisation. We make the following recommendations.

- Formal procedures should be developed and used to determine the scope and the limits of discretionary decisions. These procedures would also make national supervisors more accountable to the general public and to the fellow supervisors of other Member States. Accountability and transparency rules should refer, for instance, to the timing and the justification of an authorisation decision.
- We renew our proposal (see ESFRC Statement No. 2, October 1998) of creating an “observatory” as an institution, independent of national regulators, that regularly observes the development of systemic risk of banks in Europe, and we propose to extend the mandate of this institution, which might be called “European Banking Oversight Board” and which might or might not be part of the European Central Bank, to monitor the behaviour of national bank supervisors also with respect to discriminatory practices and lack of accountability and transparency.
- We advocate the implementation of a system of prompt corrective action (PCA) as part of the supervisory process in each individual Member State. PCA denotes an approach in

which certain values of indicators of the financial situation of a bank, such as capital and liquidity ratios, trigger predetermined supervisory measures. These measures can range from intensifying the supervisory activity to requiring capital injections up to closing the bank. Such an approach has been implemented in the USA. It is important to stress that, while we recommend similar procedures we do not recommend that they are identical in all Member States. Trigger points, for instance, and the measures foreseen in the PCA regime, need not be the same in each Member State and for all banks. PCA procedures would reduce the likelihood of a sudden banking crisis and contribute to host country supervisors' trust in home country supervisors.

3. Crisis Management and Resolution¹

While PCA procedures reduce the likelihood of banking crises, crisis management procedures should eliminate the need for emergency bail-outs and enhance the trust in non-discriminatory treatment of host-country depositors and other bank creditors (required by some national insolvency laws) in the event a bank must be closed. Furthermore, the crisis management procedures should be designed to minimise the effects of bank closure on the payment systems in home and host countries.

We believe that the current structure for crisis management in the EU is inadequate to deal with the possibility of a pan-European financial crisis. National authorities from the 25 Member States of the EU meet in a multiplicity of regulatory and supervisory committees, often with overlapping responsibilities. Despite the plethora of committees, specific institutional arrangements to deal with crisis management at the European level appear to be insufficient and, in any event, are not transparent. We propose the creation of a European Standing Committee for Crisis Management (akin to the UK tripartite Standing Committee) to alleviate some of the shortcomings of the present system.

Our proposed Standing Committee would include adequate representation of the interested parties: the ECB and NCBs, supervisory authorities, Ministers of Finance, the EC Commissioner for Competition Policy and the EC Commissioner for the Internal Market. It could meet at very short notice. Though the meeting would typically take place over the phone (or video conference), the physical location of the Committee could be in Frankfurt, the headquarters of the ECB. The composition of this Committee should vary depending on the number of countries affected by the crisis. The rule for the composition of the Committee could be based on a $3n + 3$ members, with "n" being the number of countries affected by a crisis. Hence, there would be a tripartite representation from the national central bank, supervisory authority and Minister of Finance of each Member State affected, and the 3 other members would be the EC Commissioner for Competition Policy, the EC Commissioner for the Internal Market and a representative of the ECB.

The rules of this Committee should be characterised by speed, efficiency and flexibility and should be publicised and known *ex ante*. In practice, it could work as follows: if a bank or group of banks in a Member State gets into trouble, reaching a critically low trigger point in the PCA regime, the supervisory authority in that country, together with the national central bank (if supervision is separated from the central bank) would take the lead in the procedure, keeping the Treasury/MoF informed. The NCB would immediately inform the ECB, which, in turn, would communicate with the Commissioner in Charge of Competition Policy (because of EU rules on state aid) and the Commissioner in Charge of the Internal Market (because of level playing field considerations) and

¹ Based upon Rosa Lastra's proposal, outlined in Chapter 10, *Legal Foundations of International Monetary Stability*, to be published by Oxford University Press, 2006.

with the authorities in the country/countries where spill-over effects are expected. It is important to emphasise that setting up a committee with transparent and publicly known rules of procedure does, in our view, not create a moral hazard problem since it in no way predetermines whether a given bank in a difficult situation would be bailed out or not.

Insisting on our plea for transparency we want to add a further recommendation. Multilateral memoranda of understanding were agreed in 2003 and 2005 (the first between central banks and supervisory authorities and the second also including finance ministries) to address the issue of co-operation in the case of a crisis. It is regrettable that they have not been published. In both cases, only a press release was made publicly available, but not the actual rules and procedures that would be applicable in the case of a crisis. We propose the publication of these two MoUs in the same way as the MoU that established the UK tripartite Standing Committee was published in 1997. We believe that ambiguity and uncertainty as to the procedures and loci of power are not constructive. In the event of a crisis, the procedures to follow should be crystal clear *ex ante* for the institution affected, other market participants and the public at large. Of course we expect that these procedures do not foresee a general policy of bailing out banks in trouble, since this would create the moral hazard problem.

4. Concluding remarks

Our statement suggests an approach to banking supervision which needs not be appropriate for the other two main parts of the financial industry, the securities and insurance sectors.

For banking supervision and crisis resolution, the general thrust of our recommendations is to strengthen the middle level between the national and the EU level of competence to promote the creation of an integrated, yet possibly diversified financial system in Europe and to maintain scope for regulatory competition. In line with this objective, we are not advocating “one size fits all” approaches for financial regulation, supervision and crisis management. On the contrary, we see the merits of differentiating in terms of the substance and institutions for regulation, supervision and crisis resolution. However, by introducing certain common procedural rules, we want to ensure compatibility – and thus survival – of different national approaches and, at the same time, avoid distortions of EU-wide competition.