

# European integration of financial market supervision

## Association of German Banks position paper on the future development of European supervisory structures

Berlin, June 2006

### 1. Current developments in the EU banking market and European regulatory law

A good 20 years after the political decision to create a single European market and seven years after the introduction of the euro it is clear that significant progress has been made in integrating national financial markets. Nevertheless, the level of integration is greater in the money, securities and bond markets than in retail banking, investment funds or payment systems, for example. The EU's Financial Services Action Plan (FSAP) has done much to accelerate the integration process. More and more banks are expanding their foreign business – either through cross-border mergers and acquisitions or by greater direct marketing of financial services in other member states. This enables the banking industry to tap new business potential abroad and reflects the growing internationalisation of its customers – both corporate and retail – who increasingly expect banking services to be provided across borders.

The integration of national markets to form a single European market for financial services is thus not an end in itself, but a means of adapting to changing customer demands, of encouraging competition in the financial industry by creating an environment where the same conditions apply to all and of enhancing efficiency through economies of scale. Since fixed costs account for an ever-greater proportion of the banks' total costs, the optimum operating size of a bank or a business segment is shifting upwards. It is consequently becoming more and more important to consolidate transaction volumes and centralise areas such as back-office and risk management functions. This development benefits not only internationally active customers by giving them access to a broader range of services but customers operating exclusively in the domestic market, too, because it is possible to offer more favourable terms and conditions. The financial markets are thus making a significant contribution to improving the allocation of resources and increasing macroeconomic efficiency.

Developments in the markets are mirrored in part by developments in regulatory law. Important steps have been taken in recent years to establish an increasingly harmonised legal framework for financial services providers. In the area of banking supervision, the focus is currently on national transposition of the Capital Requirements Directive (CRD), which in turn implements the new international capital adequacy framework (Basel II) and forms part of the EU's Financial Services Action Plan (FSAP). The predecessor framework, Basel I, consisted of a far less complex set of rules, which, though capturing solvency risk, followed a very rudimentary approach in weighting the individual risks on the basis of which capital charges were calculated. Basel II, in contrast, aims at capturing risk much more accurately, thus enabling capital charges to be calculated in a more sophisticated manner. This requires not only highly complex and costly risk measurement methods, but also a new quality of co-operation with regulators. Under Pillar II of the Basel framework, the supervisory review process, the exchange of information and dialogue between banks and their supervisors will be stepped up quite significantly. So for both the banks' risk management and the institutions responsible for supervising the industry, Basel II represents a paradigm shift towards more complex and quality-based supervision.

In the securities sector, a whole raft of directives were adopted under the FSAP aimed at harmonising the supervision of Europe's financial markets (e.g. the Prospectus, Transparency and Market Abuse Directives). National implementation of the Directive on Markets in Financial Instruments (MiFID), which will totally reorder the legal environment governing the conduct of investment business, is scheduled for 2007.

Closely connected with the above directives is the Lamfalussy approach, which was introduced under the FSAP with the aim of speeding up the European legislative process and making it more flexible. Three committees of European supervisory authorities were established as part of the procedure: CESR – the Committee of European Securities Regulators, CEBS – the Committee of European Banking Supervisors and CEIOPS – the Committee of European Insurance and Occupational Pensions Supervisors. These committees have an increasingly important dual role. At Level 2 of the Lamfalussy process, the European Commission issues proposals for technical implementing measures to flesh out framework directives or adapt certain aspects to changes in underlying conditions. CESR and CEBS prepare technical advice for these proposals. Subsequently, at Level 3, CESR and CEBS are responsible for ongoing harmonisation and convergence of supervisory practices in Europe. This latter task is particularly important with regard to qualitative supervisory rules, which inevitably leave scope for interpretation.

There is no one-way causal connection between market developments and substantive regulatory law; on the contrary, the two areas influence one another. Furthermore, this reciprocal relationship cannot be considered in isolation from the institutional structure of the bodies responsible for monitoring compliance with the legal framework. At present, there is a certain diversity across Europe in the organisational forms of national supervisory authorities (sectoral regulators versus bodies regulating the entire financial services industry, central banks responsible for banking supervision versus separate supervisory authorities). But a feature common to all forms is the fact that supervision continues to focus first and foremost on the individual financial institution rather than the group and that cross-border co-operation, which becomes necessary above all where international banking groups are concerned, takes place by means of bilateral agreements (memoranda of understanding). Such structures were perfectly adequate when they were first established, but in today's changed environment there is a need for adjustment. Only if supervisory structures evolve can the interplay between the development of the markets and of substantive regulatory law develop in an optimal manner.

## **2. Initiatives and papers on the future development of European supervisory structures**

How important it is for European supervisory structures to evolve effectively given developments in the financial markets and ongoing legal harmonisation is shown by the number of initiatives and papers to have been published recently on this issue by various players and institutions. The European Commission, for example, has set out its stance, put forward proposals and announced measures both in a recently published white paper on financial services policy for the coming years and in various internal working documents. In particular, the Lamfalussy process is to be extended with the aim of increasing transparency and accountability and co-operation between supervisory authorities is to be enhanced.

CEBS has launched various consultations and published papers addressing its own role, co-operation between supervisors responsible for cross-border banking groups, and deposit guarantee schemes in EU member states.<sup>1</sup> Given the increasing centralisation of

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<sup>1</sup> See CEBS CP 08 "On the role and tasks of CEBS" (July 2005), CEBS CP 09 "Guidelines for co-operation between consolidating supervisors and host supervisors" (July 2005), "CEBS technical advice on a review of aspects related to deposit guarantee schemes" (September 2005).

risk management in banking groups, it argues for a more integrated and risk-based approach to supervision.

In autumn 2004, CESR undertook a detailed analysis of its tasks in what became known as the “Himalaya Report”.<sup>2</sup> As far as the practical monitoring of market participants and the enforcement role of supervisory authorities are concerned, CESR advocates improving the co-operation and exchange of information between supervisors, which will first require some member states to provide them with adequate powers. A new paper on the fundamental role of, and co-operation between, securities regulators is scheduled for spring 2006.

It goes without saying that market participants are following and commenting on the ongoing development of supervisory structures. The European Financial Services Round Table (EFR), for example, which brings together 20 high-ranking representatives of the European financial services industry, published a position paper in summer 2005 entitled “On the Lead Supervisor Model and the Future of Financial Supervision in the EU”. The paper argues that a lead supervisor (the competent authority of the country in which a parent company has its headquarters) should be responsible not only for branches in other member states but also for legally independent subsidiaries. In addition, a “college of supervisors” should be established to ensure continuing input from the authorities in the countries where these branches or subsidiaries are located.

These documents contain a whole host of important and constructive proposals on the future development of supervisory structures, but – with the exception of CESR’s Himalaya Report – they focus mainly on the short to medium term. CESR’s paper, on the other hand, earned some criticism for its “visionary” quality and, in particular, for a failure to spell out in sufficient detail the various options proposed (such as greater centralisation of supervisory functions).

Notwithstanding the indisputable need to map out a concrete course of action for the next few years, long-term perspectives for Europe’s supervisory structures must also be developed and discussed. These need to take into account sector-specific aspects of banking and the investment business since both the supervised entities and the tasks of the supervising institutions differ considerably from one another. While the regulators of banks and financial services providers deal with a comparatively homogenous group of

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<sup>2</sup> See CESR preliminary progress report “Which supervisory tools for the EU Securities Markets?” (October 2004).

entities, securities regulators also have to monitor exchanges and other trading platforms as well as the conduct of other players on the markets (in their capacity as potential insider traders or price manipulators, for example). Another difference is the clear tendency in the securities area to regulate the nature of products and services, which is not a feature of banking supervision.

### **3. Criteria of “good” supervision**

The key role of supervisors is to ensure that the rules and regulations governing the financial industry are complied with while allowing market players to evolve in the best possible way. Any supervisory structure and its ongoing development must therefore satisfy a number of criteria:

- **Effectiveness of supervision/stability of the financial system and investor protection**

The prime task of solvency supervision is to ensure the stability of individual financial institutions, which will in turn guarantee the stability of the financial system as a whole. This means implementing international and European legislation appropriately in national law and making sure that the relevant rules and regulations are then complied with. Mechanisms must be put in place in regulatory law to deal with any crises, the possibility of which can never be totally excluded despite all monitoring of solvency and liquidity. Market supervision also involves upholding investor protection and market integrity (e.g. preventing insider trading and market manipulation). If this is done appropriately, it will contribute to the competitiveness of a financial centre.

- **Efficiency of supervision**

It is essential that supervision be efficient so that the costs of regulation, which have risen significantly in recent years, are kept as low as possible. Cross-border activity in the markets must not be hampered by unnecessarily high compliance costs. To the costs incurred directly by financial services institutions must be added the costs of operating the supervisory authorities, which are often financed in part or in full by supervised entities. This means, in particular, that regulatory rules and action must consider market realities, focus on practicalities and be flexible. Market participants should be involved to ensure that this is the case. Overregulation must be strictly avoided; the same goes for the duplication (or worse) of work for prudential purposes and on the part of supervisory authorities.

It is in the interests of legal certainty for supervisory action to be consistent over time. The volume of communication with supervisors must be kept within appropriate limits. The relationship between the effectiveness and efficiency of supervision will determine whether or not a reasonable cost-benefit ratio is ensured.

- **Level playing field**

Competitive considerations demand that all institutions receive equal treatment in comparable circumstances. This applies both at national level and to competition in the EU between member states. But there should also be a level playing field with important markets outside the EU (especially the US, Japan and Switzerland; in future increasingly India, Singapore and China as well). Supervision should thus be organised in a way that promotes, not distorts, competition. This will improve the environment for innovation at the same time.

- **Political-parliamentary oversight and transparency of supervision**

Since regulators, with their far-reaching powers to intervene, fulfil a special role in “policing” the financial services industry, they must not be permitted to operate in a vacuum. Political oversight is absolutely indispensable, though regulators should in principle be able to carry out their tasks independently within the parameters defined by law. A prerequisite for oversight of this kind is that regulators’ actions are transparent.

The debate on supervision must also address the issue of political feasibility. Should the criteria of “good” supervision outlined above indicate a need to adjust European supervisory structures, it is important to consider the impact of proposed solutions on the range of activities and responsibilities of supervisory authorities in individual member states.

#### **4. Measures necessary in the short-term**

##### **Increasing the involvement of market participants**

We believe there is room to improve the involvement of market participants at European level; this will ensure that regulatory law takes account of market realities and will enhance the efficiency of supervision. In recent years CESR has conducted intensive written consultations on all projects as far as the enormous pressure of time has allowed. In addition, meetings are held on selected issues with industry representatives nominated

by the associations. A Market Participants Consultative Panel has also been set up to comment on the way CESR is exercising its role from the perspective of the market.

By holding open hearings on certain consultation papers and establishing a market practitioners panel for the area of banking supervision, CEBS is now also taking steps to involve parties directly affected by the rules. Given the importance and complexity of the issues negotiated at EU level, however, this is not an optimum means of integrating practical expertise into the committee's work. It is true that the hearings offer an opportunity for supervisors and the banking industry to exchange views. But there is merely a single half or full-day hearing per consultation and this is normally held early in the consultation phase – that is to say at a stage where market participants have not yet completed their assessment of the issues involved. Though CEBS's consultative panel represents a welcome formalised involvement of market practitioners, it allows only limited input of practical expertise since panel members are unable to deal with the sheer number of issues handled by CEBS in the required depth.

The Association of German Banks therefore suggests that, on important and complex issues, CEBS's hearings and written consultations and CESR's existing meetings with market practitioners should be supplemented by a system along the lines of the expert bodies of the German Federal Financial Supervisory Authority (BaFin), which have proved highly useful in the area of German banking supervision. These expert bodies, which are set up to address selected major issues, bring together supervisors, banking associations and specialists from banks who are nominated by the associations. Regular meetings of the expert groups, with their fixed memberships, help to move forward regulatory law in a transparent, efficient and practicable manner. Similarly, market participants and banking associations should also be involved in the transposition workshops held to support the implementation of directives in the securities area. At present only supervisory authorities and Commission staff take part in these workshops, with the result that there is insufficient recognition of implementation problems in areas which are self-regulated by the industry (e.g. the banks' General Business Conditions). Both measures would be fully consistent with the principles pursued by the European Commission under its better regulation approach.

## **Enhancing the transparency of supervision**

CEBS should make its work more transparent. Transparent supervision is a prerequisite for market involvement, is highly important in its own right (e.g. timely publication of supervisors' joint decisions on interpretation issues) and furthers the convergence of supervisory practice. CEBS has already taken steps in the right direction by setting up internet pages and publishing its annual work programmes; further information, both on the results of deliberations in the committees and working groups and on CEBS's working methods and procedures, would be highly desirable, however. Publication of summarised information and statistics on the exercise of options and the application of qualitative rules would also be useful. Transparency on the part of supervisors is an indispensable counterpart to the disclosure by banks which Basel II has radically expanded and has the potential to deliver positive "market discipline" among supervisory authorities, too.

CESR, on the other hand, already has a high standard of transparency. This should be maintained. Nevertheless, there is some cause for concern regarding the planned mediation mechanism, which currently envisages no transparency requirements vis-à-vis market participants. If the findings of a case are of general relevance, they should be made public.

## **Convergence of supervisory practice**

Germany's private banks also see a need for action on the specification, interpretation and practical application of supervisory rules. CESR and CEBS can, and should, play a key role in this context. Along with drawing up proposals for technical implementing measures at Level 2, the Committees are charged at Level 3 with the convergence and harmonisation of supervisory practice. It is too soon for an initial assessment of CEBS's and CESR's work in this area. Nevertheless, it is clear that convergence towards consistent supervisory practices across Europe in the medium term is tremendously important both for the banking industry in general for competitive considerations and for internationally active banking groups in particular in terms of cutting the costs of supervision. The Capital Requirements Directive (CRD) on implementing Basel II, for instance, contains numerous national options and qualitative rules in need of interpretation. These must not be allowed to result to differences in the regulatory environment from one member state to another. An international level playing field will never be established if

supervisors are unable to agree on common (non-legislative) standards – as is to be feared with the COREP and FINREP projects – but merely on minimum standards (“lowest common denominator”), which member states are at liberty to add to at will.

At the same time, it must be ensured that there is no attempt to introduce rules proposed by CESR and CEBS but not taken up by the Commission at Level 2 in the form of supervisory guidelines at Level 3. This would undermine the Lamfalussy process. Furthermore, Level 3 measures must be formulated in such a way that they are interpreted and applied consistently in all member states.

### **Implementation of the consolidated supervisor concept**

A major feature of European banking supervision law to date is that, in general, supervision takes place both at the level of the individual bank (solo supervision) and at the level of the banking group. The result, particularly for big banking groups with a number of legally independent subsidiaries in various member states, is costly duplication of work, contradictory requirements and highly onerous co-ordination with all the different competent authorities involved. The focus on solo supervision leads to inefficiencies and is at odds with recent developments in the industry, where the group level is becoming increasingly important. Sound credit rating systems, for example – a core element of Basel II – are normally only commercially feasible at group level due to the amount and quality of data and data history involved. Capital management is now also usually handled at group level since it is relatively straightforward to transfer capital and risk assets within a group. Strategic decisions, too, are generally taken with the group as a whole in mind. This all demonstrates that today’s increasingly complex banking groups can no longer be evaluated from a purely national perspective (solo supervision).

European legislators have taken account of this development in Article 129 of the CRD. This gives responsibility for recognising internal rating systems for the entire banking group to the competent authority of the parent company (consolidated supervisor / home supervisor). This is required to listen to and involve the authorities responsible for supervising subsidiary companies (host supervisors). If it does not prove possible to reach a consensus within six months, however, it is up to the consolidated supervisor to take a final, binding decision.

This new concept involves a real surrender of sovereignty, admittedly limited initially to the recognition of rating systems. Yet the envisaged departure from the principle of multiple supervision at both solo and group levels marks an important and correct step in the development of European regulatory law.

For the consolidated supervisor concept to function smoothly, co-operation and the exchange of information between supervisory authorities will need to be significantly stepped up. Important practical legal questions will also have to be clarified, such as whether an administrative act issued by the consolidated supervisor applies across borders, which area of jurisdiction applies in the event of a legal dispute and who should be financially liable for any irregularities in the supervisor's actions.

The consolidated supervisor concept has yet to find a place in the area of securities supervision. Yet here, too, the question arises as to the future relationship between home and host country supervision. CESR has recently also been considering the issue of transferring responsibilities and powers from one authority to another.

When deciding whether consolidated supervision might make good sense in the securities areas, a distinction should be made between organisational requirements to be met by market players and supervision of the markets themselves. Where the former are concerned, it would be advantageous to entrust more tasks to an authority responsible for supervising at group level. It would not, in contrast, necessarily be beneficial to consolidate supervisory activity focusing on the actual market. Transaction reporting to the home supervisor, for example, may appear an effective solution at first sight, but the information really needs to be evaluated as it relates to the affected market. This means the home supervisor would have to transfer the data back to the competent authority in the host country, which would ultimately push up the costs for the banks. Shifting responsibilities for supervising the market would only make life easier if they were entrusted to an EU financial services authority with powers to supervise the entire European market (see below).

## **5. Medium to long-term measures**

### **Permanent legal basis for the Lamfalussy process**

Even if CESR and CEBS carry out their major tasks satisfactorily in the coming years, the Lamfalussy process needs to be put onto a permanent legal footing. One of the consequences of the failure of the European Constitution is that the planned "call-back"

option could not be enshrined in law. The intention was to provide the European Parliament and the Council with a guarantee that the Commission could not pass any rules which exceeded the scope of technical implementing measures. Though the CRD explicitly enshrines the use of the Lamfalussy process, its application is limited by a sunset clause to 1 April 2008. Various other securities-related directives also contain sunset clauses.

A permanent basis must be created for the Lamfalussy process by 2008 so that the practical needs of market participants can be accommodated while at the same time safeguarding the rights of the European Parliament and ensuring that supervisors' actions are subject to political-parliamentary control. Given the complex diversity of interests that have to be taken into account, this issue should be addressed and possible solutions discussed as soon as possible. In its December 2005 white paper<sup>3</sup>, the European Commission expressly states that the transparency of the Lamfalussy process needs to be enhanced and accountability to the European Parliament and the Council improved. Based on experience gained with the co-operation between supervisory authorities until 2008, their collaboration in CESR and CEBS will also have to be evaluated.

### **Extension of the consolidated supervisor to a lead supervisor system**

The system of dual supervision at solo and group level, whose prevalence is largely due to historical factors and which is increasingly unsuited to today's requirements, should be phased out in the medium to long term. Extending the role of the consolidated supervisor to that of a lead supervisor would shift the focus of supervision to group level, where it belongs. The banks could avoid costly duplication of work and onerous co-ordination; the general trend towards "group-level handling" would also be reflected in the regulatory arena. Multinational banking groups would have "one-stop supervision", at least within the EU.

Nevertheless, in the interests of both political feasibility and effective crisis management, there should also be close involvement of the supervisory authorities in areas where

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<sup>3</sup> "White Paper on Financial Services Policy 2005-2010" (COM(2005) 629 final).

important subsidiaries of the group are located. Exchange of information in the form of bilateral agreements between regulators or in a “college of supervisors”, for example, would enhance the quality and acceptance of supervisors’ decisions without jeopardising the clear allocation of powers to the level of the parent company. In addition, there would be a need for further harmonisation of regulatory law (including moving away from minimum requirements which can be topped up by additional national rules) in order to guarantee a level playing field for all market participants under the lead supervisor model.

The Association of German Banks does not believe a parallel reform of member states’ deposit protection systems is necessary since the various existing schemes permitted under the European Deposit Guarantee Schemes Directive have proved successful. This position, moreover, is in line with the views of CEBS. In its September 2005 report “Advice on Deposit Guarantee Schemes”, CEBS concludes that the diversity of the schemes poses no obstacle to financial market integration and that there is consequently no need for major modifications. Conversely, CEBS stresses that changes in this area would give rise to “disproportionate costs”.

### **Creation of a system of European financial services authorities**

In a European financial market that is becoming increasingly integrated, the lead supervisor model can probably only offer an interim solution, however. In a true single market, a far-reaching and wide-ranging process of development might culminate in a European System of Financial Services Authorities. The centrepiece of such a system would be (as in the European System of Central Banks, ESCB) a single European agency supervising – solely, it must be stressed – large financial institutions with significant volume of cross-border business. The tasks of the national authorities would then comprise the monitoring of institutions operating on a domestic basis and local input into the supervision of internationally active banks.

In the interests of fair competition, domestic and cross-border banks would have to be supervised on the basis of identical rules. Furthermore, supervisory practices would need to be harmonised to exclude the possibility of differences in interpretation and application at the various levels and to ensure a level playing field in this respect, too. Interaction between a European agency and the national supervisory authorities would do much to support crisis management. The prerequisites for such a structure are wide scale harmonisation of regulatory law in the banking and securities area, the creation of the necessary framework in Community, constitutional and administrative law, adequate crisis management systems as well as political oversight and accountability mechanisms.

A single European supervisory system would have several advantages over the lead supervisor model. Competitive distortions which could not be totally ruled out as a result of differing interpretations across member states under the lead supervisor regime could be excluded from the outset. Nor would there be any possibility of regulatory arbitrage in the form of strategic relocation to another country of the parent company or certain market activities. Furthermore, duplication of work, which might still arise to a certain extent under the lead supervisor or college of supervisors model, could be avoided. What is more, the consequences for national supervisory authorities would be considerably more even: in a lead supervisor system, the implications would be very different for countries where international banking groups were located and countries where most banks were foreign-owned subsidiaries. This is an important aspect in terms of political feasibility.

The creation of such a system of European supervisory authorities will take place at the end of the process of European integration. In the course of this process a balance will have to be struck among all the political and economic interests of Europe's financial centres as well as with countries – especially the Eastern European new member states – whose financial markets have a high proportion of banks under foreign ownership. Problems arising during the interim steps outlined above will need to be solved in a manner acceptable to all those involved. This requires an ongoing evaluation and reporting process, which should be conducted by, and for which responsibility should lie with, the European Commission.