# Financial Architecture

## 1. Introduction

There has been much progress in the integration of European financial markets since the lifting of capital controls during the 1980s, the First and Second Banking Directives (1977 and 1989), the Single Market Programme and monetary union. However, the European banking market, especially in its retail sector, continues to be segmented, and many obstacles remain on the way. For example, most of the mergers and acquisitions (M&A) activity is domestic. Furthermore, the emergence of pan-European stock exchanges has been delayed for a variety of reasons, but especially because of regulatory barriers. Indeed, there seems to be growing disenchantment because of the resiliency of the obstacles to the integration of financial markets. Arguably, regulatory fragmentation constitutes the major obstacle to the integration of financial and banking markets in Europe. Questions have also been raised about the adequacy of present arrangements to preserve stability in the euro area.

According to the "official" view, the present decentralised supervisory arrangements of the banking and financial markets in Europe are adequate because of the existing segmentation of business by country. Despite this, several committees and groups (Brouwer, Lamfalussy, Giovannini) have been set up to study the obstacles to financial market integration and propose solutions to improve the regulatory and supervisory frameworks. By and large, those committees have recommended more co-operation among supervisors (Brouwer in particular) as well as the adoption of a "comitology" procedure (delegation of powers to define rules to a committee) to speed up the implementation of financial legislation (Lamfalussy in particular).

Many political economy issues are at the heart of the regulatory fragmentation problem, in particular the tension between economic integration and the lack of willingness to relinquish national political control. But while these political economy issues slow down the pace of regulatory and institutional innovations, there are important sources of systemic risk to which the European markets are exposed. Recent events have stressed the threat of terrorist action, and possible financial weakness associated with the current slow-down. Some European banks are heavily exposed to emerging markets and to particular sectors, such as telecoms, which have recently experienced deep crises. The process of consolidation within countries has led to the creation of many "national champions" that may create incentives for national authorities to provide excessive guarantees. At the same time, the expansion of cross-border activities may increase potential spillovers and externalities across countries, while creating incentives for the underprovision of supervision and liquidity support by national authorities.

In this chapter we review the financial architecture of the euro area, take stock of some of the proposals for reform, and suggest ways to progress.

We argue that there are at least three open problems with the present financial architecture arrangements in the euro area.

First, these arrangements may not be adequate for financial stability. For instance, in the event of a crisis, there is no clear chain of command among the institutions potentially involved in the intervention. How would the Eurosystem react to the threat of a major disruption like LTCM? Who in Europe would have the responsibility to organise a rescue like that of the president of the New York Fed in the United States? A response based on improvised co-operation may not be enough and may come too late. Moreover, there could be misaligned incentives for national supervisors dealing with transnational firms, as they do not internalise cross-border spillovers from the crisis of such firms. Conversely, national authorities may have strong incentives to provide excessive help to national champions.

Second, to a large extent, the present arrangements hinder European financial market integration. Legislation is slow, rigid, and lags behind market developments. Regulatory fragmentation prevents the emergence of deep, liquid European markets (see for instance the failure of iX). Protection of national champions and regulatory barriers prevent the emergence of pan-European banks.

Finally, the present arrangements hinder the competitiveness of EU financial markets and institutions.

The present gradualist approach may yield more costs than benefits in the longterm and may end up

proving ineffective. It would be better not to wait for a major crisis to strike in order to put the house in order. To have a passive policy regarding the lack of financial integration of certain segments of the financial market may backfire, as it fails to remove obstacles to integration and endangers stability.

While endorsing in general the well-intentioned recommendations of the committees and groups seeking to remove the obstacles to European financial integration, we feel that a more ambitious approach is needed. This is so because alternative models for reforming the financial architecture in Europe will have profound implications for the degree of financial market integration, competitiveness in the financial industry, and financial and monetary stability.

Reform proposals should be assessed in terms of their contributions to the welfare of European citizens, including the price they will pay for financial and payment services, the range of opportunity for insurance and portfolio diversification, the reliability and trustworthiness of the financial institutions in the area. Those criteria lead us to propose some reforms in the European financial architecture, distinguishing short-run measures and calling for a debate on the basic framework with a long-run view.

In the short run, clear procedures should be established for crisis lending and crisis management with the European Central Bank at the centre. The crisis framework should be put in place now and the fiscal issue of how to provide help to a transnational institution confronted.

A debate should be opened with a view towards evaluating the benefits of more centralised supervisory arrangements in banking, insurance and securities in the medium and long run. In particular, in addition to the current decentralised regulatory competition frame, two basic long run models should be discussed:

- In the first model, the ECB, in the context of the ESCB, would be given a larger role in the supervision of banking, with the contemporaneous creation of separate specialised European-wide supervisors in securities and insurance.
- In the second model, an integrated supervisor would be constituted, a European Financial Services Authority, and the ECB would have access to supervisory information in order to maintain systemic stability.

In either of the two models supervision need not be completely centralised at the European level. First, because national supervisors will be involved in the day to day supervisory operations. Second, because European level agencies could leave entities trading mostly within one national jurisdiction to be supervised by the appropriate national regulator (under the home-country principle).

An implication of our vision is that the door should be left open in the Convention on the Future of Europe for the necessary institutional changes to implement more centralised regulation, perhaps along the lines of one of the models above.

Last but not least, the EU wide competition policy in the banking sector, which limits help to national champions that are "too big to fail", and removes obstacles to cross-border mergers, should continue. At the same time, domestic competition policy should be reinforced to keep in check local market power in national markets.

Reforms of the financial architecture are admittedly complex, as technical aspects are strictly interwoven with legal and institutional aspects. Given the large interests at stake, the process of reform is the target of particularly strong lobbies, both private and public. It would be a great cost for society if the need to reconcile conflicting special interests resulted in lower protection of European citizens against the many risks that an inefficient and vulnerable financial system entails.

The plan of the chapter is as follows. Section 2 will look at the state of European financial integration and the impact of the euro while Section 3 will describe present arrangements in terms of financial stability, regulation and supervision, and competition policy. Section 4 will deal with problems of the present regulatory framework and Section 5 will look ahead, rethinking European financial architecture.[1]

## 2. European financial integration and the impact of the euro

The process of European financial integration coincides with the general trend in the financial services industry towards liberalisation, regulatory

[1] The reader is referred to Vives (2000, 2001) for a development of some of the arguments presented in this chapter.

reform, and globalisation (encompassing advances in information technology and communications). These changes have increased competition, as well as the weight of markets in relation to financial intermediaries ("disintermediation"), although banking is not receding in real terms. For the banking sector, the result is a move from the traditional business of taking deposits and granting loans (earning money on the financial margin) to the provision of services to investors and firms (earning money by charging fees and commissions). There is a move from investment in branches to investment in communication networks, information technology, and specialised human capital. In general, the transformation of the banking sector (in terms of development of mutual and pension funds, insurance, a corporate debt market, and venture capital) is less advanced in Europe than in the United States.

The measures undertaken to date to foster the integration of financial markets in Europe (from the Banking Directives and the Single Market Programme to the introduction of the euro) have produced mixed results.

The euro-area money market has become substantially integrated, although the degree of integration varies in the different segments. For example, integration is complete for unsecured interbank deposits, as well as for euro-derivatives. Integration is less pronounced for secured money market segments, where liquidity is exchanged for collateral (like commercial paper, CDs, Treasury bills and private repurchase agreements). National disparities in cross-border clearing and settlement are an obstacle to integration.

The euro-denominated bond market has become much more homogeneous since the introduction of the euro and has increased in depth and liquidity. Sovereign issuance remains a dominant source of supply and until 1998 was associated with the convergence of yields. However, yield convergence has virtually stopped since 1998, as differentials have been reduced to those related to the size of individual issues.[2] Smaller member states are not able to provide enough issuance volume in all maturities to reap the full benefits of the unified yield curve. Co-ordinated issuance could alleviate this problem.

The euro seems to have stimulated cross-border equity investment and the consolidation of stock exchanges (a successful example is the merger of the Amsterdam, Brussels and Paris exchanges to form Euronext in 2000).

Despite the trend towards integration in capital markets, the European banking retail market continues to be segmented, and the degree of cross-border penetration is small.[3] In addition to regulatory barriers, existing branch networks and relationships with clients are important obstacles to entry in the retail sector, and there are significant switching costs for customers.[4] The lack of integration is most apparent in the markets for consumer credit and mortgages. Regulatory restrictions governing the composition of the portfolio of institutional investors, such as pension funds and insurance companies, are a source of market segmentation in asset management. The lack of integration of the retail market also characterises electronic banking, which remains very limited (with some exceptions in the Nordic countries and the United Kingdom). As the European Commission has stated, cross-border retail fees are high and have maintained a high degree of dispersion in the last decade. In 2001, the European Commission introduced a regulation of cross-border payments in euros because of the little progress observed in reducing price differentials. At the same time, cross-border securities trade is much more expensive than trade within the national boundaries (see Economic Financial and Committee, 2002.)

In general, important differences among countries remain in terms of the degree of competition, amount of rationalisation of the banking sector, financial strength of banks, and progress in the transformation towards a services industry.[5]

Consolidation among banks is taking place in Europe mostly through domestic mergers (see Table 4.1). In contrast to the United States, obstacles to cross-border mergers in Europe consist of restrictions on labour mobility, differences in cor-

[2] See Chapter 4 in European Commission (2001).

[3] For example, the market share of subsidiaries and branches of foreign credit institutions as a percentage of the total assets of domestic credit was less than 13 percent for the euro-area average asat the end of 1997 (see ECB, 1999). The exceptions are Belgium, Ireland and Luxembourg.

[4] In spite of this, French and German banks have foreign assets in branches and subsidiaries amounting to about a third of domestic assets (see ECB, 1999).

[5] For example, some countries lag behind in the move towards services, like France, Italy, and Spain as compared to Germany or the United Kingdom.

**Table 4.1**

**Merger and acquisition activity in the euro-area financial industry[a)]**

| | Same country | | Other euro country | | Other non-euro country | | Total | | As a percentage[b)] | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Nb.[c)] | Value[d)] | Nb. | Value[d)] | Nb. | Value[d)] | Nb. | Value[d)] | Nb. | Value[d)] |
| Banks-banks | | | | | | | | | | |
| 1998 | 7 | 8,445 | 1 | 147 | 12 | 13,787 | 20 | 22,379 | 12.7 | 13.0 |
| 1999 | 9 | 41,242 | 4 | 9,465 | 15 | 7,495 | 28 | 58,202 | 15.9 | 34.2 |
| 2000[e)] | 3 | 4,528 | 0 | 0 | 5 | 11,654 | 8 | 16,182 | 26.7 | 62.0 |
| Banks-non-bank financial | | | | | | | | | | |
| 1998 | 7 | 28,604 | 1 | 646 | 3 | 897 | 8 | 31,147 | 24.2 | 37.9 |
| 1999 | 3 | 20,816 | 1 | 800 | 12 | 4,130 | 16 | 25,746 | 20.8 | 56.4 |
| 2000[e)] | 8 | 4,768 | 1 | 1,631 | 4 | 653 | 13 | 7,052 | 48.1 | 39.1 |
| Non-bank financial – non-bank financial | | | | | | | | | | |
| 1998 | 6 | 7,299 | 2 | 7,974 | 7 | 1,201 | 15 | 16,474 | 11.8 | 13.8 |
| 1999 | 11 | 15,508 | 4 | 378 | 19 | 21,888 | 34 | 37,774 | 15.7 | 40.7 |
| 2000[e)] | 4 | 5,071 | 1 | 9 | 5 | 454 | 10 | 5,534 | 23.3 | 18.8 |

[a)] Either acquirer or target company is resident in the euro-area. Only completed or pending deals, announcement date volumes. – [b)] Of mergers and acquisitions in all countries. – [c)] Nb. = Number. – [d)] In millions of US dollars. – [e)] 1 January to 10 April.

Source: BIS (2000, p. 134).

porate culture, and political interference (for example, promotion of national champions).[6] Nevertheless, international deals predominated among insurance companies in the period 1985–1997. Furthermore, in the same period, mergers and acquisitions (M&A) deals tend to be concentrated among the same type of institutions, rather than being targeted to create conglomerates (Berger, DeYoung, and Udell, 2000). An interesting feature of cross-border banking in Europe is that it often takes the form of subsidiary instead of branch. This is the case, for example, of the cross-border mergers and acquisitions involved in the formation of Nordea AB, ING Group and HypoVereinsbank (see Dermine, 2002) as holding companies with subsidiaries.

One issue with domestic mergers is that they tend to increase local concentration, which is what matters for the exercise of monopoly power in retail banking. In 1997, the C5 deposit ratio (the share of deposits of the five largest institutions) had a value which was similar for the EU and the United States (around 12 percent).[7] Yet, because of the weight of interstate mergers, the current consolidation process in the United States has not generated a clear trend towards local concentration (Berger, Demsetz, and Strahan, 1999). With very limited cross-country mergers, the situation in Europe is more worrisome.

*2.1 Has the level of risk increased?*

Consistent with the international evidence (Demirgüç-Kunt and Detragiache, 1998), liberalisation in Europe has also been associated with bank failures. Table 4.2 shows the fiscal costs of

[6] In the United States, recent studies indicate that there are sizeable economies of diversification in macroeconomic risk that can be exploited by means of mergers of entities in different states (Hughes et al., 1996, 1998). In Europe these economies of international diversification are partly limited by the increasing correlation in the business cycles of different countries (and the reduction in correlation between regions belonging to the same country). However, Berger, DeYoung, and Udell (2000) report that correlations of bank earnings across European nations are low, or even negative, relative to those across states in the United States.

[7] National concentration levels in banking are much higher in European countries than in the United States at large, and they have tended to increase, particularly for smaller countries. For example, the concentration ratio C5 for deposits ranges from 30 to 80 percent in EU countries, with the exception of Germany which is less concentrated.

**Table 4.2**

**Fiscal costs of select banking crisis**

| | Period | Fiscal cost (% of GDP) | Blanket guarantee for depositors and creditors | Extensive liquidity support to financial intermediaries |
|---|---|---|---|---|
| Spain | 1977 – 85 | 5.6 | No | Yes |
| France | 1994 – 95 | 0.7 | No | No |
| Finland | 1991 – 94 | 11.0 | Yes | Yes |
| Sweden | 1991 – 94 | 4.0 | Yes | No |
| USA | 1981 – 91 | 3.2 | No | No |
| Japan | 1992 present | 20.0 | Yes | Yes |

Source: The EU Economy 2001 Review (2001) and Honohan and Klingebiel (2001).

selected banking crises in Europe, compared with Japan and the United States. The table shows that the costs of European banking crisis have been comparable to the experience of other countries.[8]

Because of pressure on margins due to disintermediation and the general increase in competition in local markets, European banks have increasingly looked for markets with larger margins abroad. As a result, in the second half of the 1990s, the exposure of European banks to emerging markets was several times larger than that of US banks. If we break down the income of large European banks by geographical origin (including off-balance sheet activities), we see that a substantial part is earned abroad (about 33 percent in 1998, more than half of which is earned outside the EU). The largest Spanish banks, for instance, have very high exposure in Latin America (SCH in Brazil and BBVA in Mexico). By the same token, international interbank claims of EU banks have grown substantially. In 1998 international claims by banks located in the EU on banks located outside (in) the EU represented 7 percent (12 percent) of the total balance sheet of the EU banking system (see Economic and Financial Committee, 2000.) These data point to high risk-taking, especially by large banks, leading to non-negligible systemic risk.

At the same time the wave of domestic consolidation has created banks that are large in relation to some national economies, particularly in small economies like Switzerland and the Netherlands, but also in larger ones like Spain. This means that trouble in some of these "national champions", with its possible systemic consequences, may come at a high cost. For example, the book value of equity to national GDP ratio (2000) for UBS and Crédit Suisse in Switzerland is 12.4 percent and 10.5 percent, respectively; for ING Group in the Netherlands it is 6.6 percent and for SCH in Spain it is 4.3 percent.

In other words, while financial market integration provides opportunities for better diversification (for example with cross-border M&As)[9], it also provides incentives for higher risk-taking, increasing the level of systemic risk and vulnerability to contagion.

### 3. The present arrangements

In addition to the development of national legislation, financial regulatory institutions in the euro area derive from the Treaty of the European Union and European Commission Directives. Competition policy also goes back to the Treaty of Rome. This section will illustrate the present regulatory situation in terms of crisis lending and management, regulation and supervision, and competition policy. We leave to boxes 4.1 to 4.3 a brief discussion of the theoretical arguments for financial

**Box 4.1**

**The rationale for financial regulation**

- *Fragility and its consequences.* Because of currency and maturity mismatch between assets and liabilities, the banking and financial system is vulnerable to sudden losses of funds resulting in the failure of fundamentally solvent intermediaries. Experience shows that panics and systemic crises compromising the banking and financial system may have a major impact on the real sector of the economy (as suggested by the examples of the Great Depression of the 1930s, the 1998 international financial crisis, or the on-going crisis in Japan).
- *Co-ordination failure of investors and runs.* In the case of a purely speculative panic, depositors withdraw their funds and force the bank to early and costly liquidation of assets. A panic can be generated by news regarding bank solvency problems. In this case, the possibility of depositors' runs may have a disciplinary effect on risk taking by financial intermediaries (see Diamond and Dybvig, 1983; Jacklin and Bhattacharya, 1988; and Postlewaite and Vives, 1987.)
- *Contagion and systemic risk.* The bankruptcy of one financial intermediary can have systemic consequences, owing to contagion effects which may give rise to strong negative externalities for both the financial sector and the real sector of the economy. The failure of one institution may jeopardise the solvency of other institutions via default on commitments assumed in the interbank market. Large variations in the price of assets such as an abrupt fall of stock prices or the failure of a major intermediary, may generate a domino effect and systemic crisis affecting the payment system.
- *Why regulation?* Regulation aims at providing the banking and financial systems with stability to elude the negative effects associated with failing institutions and systemic crises. A second aim is to protect small investors and customers of firms providing financial services.

[8] In the crises in Spain and in Scandinavia, also factors other than financial liberalisation were involved, that is the economic recession in Spain and, in Scandinavia, errors in fiscal and monetary policies which helped to inflate the speculative bubble. In all cases there was poor management, along with deficiencies in banking supervision.

[9] There is an argument pointing at a stronger need for diversification of credit risk in a single rrency area. As a single monetary policy responds to an average of shocks hitting the different regions of the euro area, it becomes less effective (relative to national monetary policies) in stabilising local demand conditions. Hence, after the introduction of the euro, the possibility of asymmetric business cycle developments increases the credit risk in any specific region of the Union. Obviously, this effect has to be set against the smaller exchange rate risk between euro countries.

**Box 4.2**

**Financial stability facilities**

*Crisis lending and the central bank:* An important discretionary activity of the central bank consists in helping banks experiencing temporary liquidity problems via the discount window or open-market operations. The central bank can create liquidity as needed, and can credibly commit to unlimited lending and fast reaction because of its control of high-powered money. Alternative arrangements to provide liquidity involving private money (lifeboats, liquidity consortia) or funds raised with taxes (via deposit insurance funds, building "war chests", or direct recourse to the finance ministry) are costly and in general can be at best part of a solution in which the central bank is also involved.

*Crisis management:* A crisis manager helps to solve the co-ordination problem among creditors that a crisis entails. In many instances the *lender of last resort* (LLR) manages the crisis but does not put up its own funds, which may be private money (as in the rescue of Long-Term Capital Management (LTCM) co-ordinated by the Federal Reserve Bank of New York, see next paragraph), or money from the deposit insurance fund or the taxpayer (Goodhart and Shoenmaker, 1995).

*Examples of crisis management:* The stock-market crisis of 1987 provoked problems in the clearing systems of the derivative markets and was overcome thanks to an injection of liquidity by the Federal Reserve. Financial intermediaries required additional funds to meet the needs of their clients with margin calls. Indeed, intermediaries in the capital and money markets were assisted by bank credit lines in providing liquidity. In the crisis of the hedge fund LTCM, after Russia's default in 1998, LTCM had to be recapitalised in order to meet the margin requirements in derivatives when the market spreads moved adversely to the position of the fund. The Federal Reserve Bank of New York organised a rescue operation with investment banks that were investors in the fund. According to the Fed, the hasty liquidation of the (large) fund positions could have caused a major disruption in world financial markets.

*The classic Lender of Last Resort (LLR):* The classic prescription for the LLR (associated with Bagehot, see Meltzer, 1986) is that funds should be provided only to solvent banks with liquidity problems. These banks are to be helped with loans at a penalty rate and against good collateral, evaluated in "normal" conditions. The solvency and collateral terms under which help will be given must be clearly stated and the LLR must announce its readiness to lend without limit. Goodfriend and King (1988) have disputed this "banking policy" view arguing that in developed financial systems a solvent bank cannot be illiquid and therefore only open-market operations are needed. Rochet and Vives (2002) provide a modern justification of Bagehot's view.

*Deposit insurance:* Deposit insurance is a non-discretionary activity by means of which deposits are protected up to predetermined limits. If the limits are not very high, it meets the aim of protecting the small investor.

*Too-Big-To-Fail (TBTF) policy:* Often banks and depositors are protected above the levels required by the deposit insurance scheme. Under the TBTF policy a large insolvent bank will be rescued (and its uninsured depositors will be protected) whenever its failure is likely to affect other banks, via the interbank market, and the real economy.

regulation, the regulatory facilities in place to guarantee financial stability, and the moral hazard problem motivating the need for prudential supervision.

### *3.1 Crisis lending and management*

The monetary authority under the Treaty of the EU is the European System of Central Banks (ESCB or Eurosystem), made up of the European Central Bank (ECB) and the national central banks (NCBs). The ESCB has the narrow mandate to maintain price stability, and without prejudice to this objective, it should support the general economic policies of the EU (Article 105(1) of the Treaty). The ESCB is subordinate to the national governments and to other European institutions in the area of financial supervision and the stability of the European financial and banking systems: "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Article 105(5)).

In summary, the Treaty does not put the ESCB explicitly in charge of the stability of the financial system, although there is recognition of the ESCB's task of promoting the harmonised operation of the payments system (Article 105(2)). However, the ECB has a consulting role in legislation regarding financial institutions in so far as they may affect stability (Article 105(4) and EU Council Decision 98/415/EC), and its role with respect to questions of supervision can be larger: "The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings" (Article 105(6)). This means that the ECB could be assigned supervisory powers, with the exception of insurance, without the need to reform the Treaty of the EU.

**Box 4.3**

**Regulation, prudential supervision and moral hazard**

- *Moral hazard.* Both the Too-Big-To-Fail policy and the deposit insurance system reduce the incentive of depositors and investors to monitor bank performance. Excessive risk taking may then derive from the bank's limited liability charter and the non-observability of the risk level in the bank portfolio. Moral hazard also arises because the effort of bank managers in monitoring projects is not observable.
- *Time-inconsistency.* A well-intentioned LLR will find it optimal ex post to help a bank whenever this salvages the value of projects that the bank is financing. Indeed, ex ante the central bank may want to commit to close the bank if the returns are very low (signalling a solvency problem) while helping the bank if the returns are only moderately low (signalling a liquidity problem). Such a commitment provides incentives for bank managers to monitor the projects they finance. However, ex post, costly liquidation of the projects will not be optimal, so the central bank may hesitate to carry out its threat. The commitment problem is compounded by the interest of the bank management in the continuation of the bank. Bankers, anticipating the help, will tend to exert suboptimal effort in monitoring projects and take excessive risk.
- *Alleviating the excessive bailout problem.*
  - A central bank with a "tough" reputation can alleviate the time-inconsistency problem. Credible central banks typically adopt a "constructive ambiguity" policy, not making explicit the criteria under which entities with problems will have access to help.
  - Alternatively, external discipline can be imported into a small open economy by adopting another (stable) currency ("dollarising"), entering into a credible monetary union (like EMU), and/or acquiring foreign short-term debt. In all those instances a firm commitment is acquired (with dollarisation because recourse to the LLR is drastically limited, with a monetary union because of the credibility of the central bank, and with foreign short-term debt because it cannot be inflated away, see Gale and Vives (2002) and Vives (2002)).
  - Another way to import discipline for countries which have difficulties building a reputation for the central bank, is by transferring political sovereignty, forming a monetary union and establishing an independent and credible central bank. For this to succeed, some of the participants' central banks must have already established a credible reputation.
- *Prudential supervision.* The general trend in prudential supervision is to check risk-taking with capital requirements and appropriate supervisory controls. Both risk-based deposit insurance and disclosure improvements have been proposed to limit risk-taking behaviour. However, while it is feasible to introduce disclosure requirements of the banks' market positions, it is more difficult to assess the risk level of the illiquid loan portfolio of a bank. (See Matutes and Vives, 2000, and Cordella and Yeyati, 2002.) Furthermore, more disclosure may in fact induce information-based runs of depositors generating instability.

Only relatively recently has the ECB raised its profile in crisis management. The first official statement we are aware of is Duisenberg's October 1999 declaration in the European Parliament:[10]

"The main guiding principle within the Eurosystem with reference to the provision of emergency liquidity to individual financial institutions is that the competent national central bank would be responsible for providing such assistance to those institutions operating within its jurisdiction. The ECB does, however, have to be informed of this in a timely manner. In addition, in operations of relevance to the single monetary policy, the decision-making bodies of the Eurosystem will be involved in assessing the compatibility of the envisaged operations with the pursuit of monetary stability. In the case of a general liquidity crisis resulting from a gridlock in the payment system, for instance, the direct involvement of the Eurosystem could be expected."

The central bank is the natural candidate for the lender of last resort function (LLR) in a financial system (see Box 4.2). The Federal Reserve and the Bank of England are explicitly in charge of the stability of the financial system (but the Bundesbank was not). For example, the Federal Reserve Board (FRB) determines the policy regarding supervision and last-resort lending on the part of the banks of the Federal Reserve System. The FRB determines the conditions under which discount-window loans will be granted by the Federal Reserve banks and, in practice, the FRB is consulted regarding any major loan. Most likely, the reason behind the lack of formal responsibility of the ECB on stability matters is that there is no central European fiscal authority. Typically, a central bank turns to the finance ministry or specialised agencies, like a deposit insurance fund, when an assisted bank turns out to be insolvent.

[10] See also Padoa-Schioppa, 1999, member of the Executive Board of the ECB in charge of prudential supervision. The quotation in the text is from the introductory statement delivered on the occasion of the Presentation of the ECB's Annual Report 1998 to the European Parliament in Strasbourg, 26 October 1999.

*3.2 Regulations and Supervision*

*The home country control principle and regulatory competition*

The Single Market in financial services builds on the single banking licence, together with the principles of home country control and of mutual recognition (Second Banking Directive, effective since 1993).[11] If a financial institution is authorised to operate in one European country, it may offer or establish financial services anywhere else. That is, the financial institution can branch from one member country to any other member country.[12] The Second Banking Directive establishes the control of the home country (that is the member state in which the financial institution has been authorised) for the prudential supervision of solvency and of major risks, and a minimum harmonisation between countries in other areas, such as minimum capital requirements, concentration of risks, and protection of investors.[13] The Directive regarding deposit insurance proposes a minimum coverage (up to €20,000), which tends to reflect an interest more in protecting the small investor than in protecting the stability of the banking system. Deposit insurance is organised according to the home country principle: a bank granted a licence in a EU country is insured by the deposit insurance system of the home country when it operates in another EU country. However, a foreign branch may join a more favourable host country scheme.

The principles of home country control and mutual recognition lay out a regulatory competition framework. This framework may encourage information production and limit the potential opportunism of the national regulators. Country discretion ranges from legal differences in financial contracts, the organisation and conduct of banking supervision, the structure of deposit insurance schemes, and the institutions and procedures to restructure banks. For example, the administration of deposit insurance may be in the hands of either the government or the banking sector, or both. In general, deposit insurance premia are a flat percentage of deposits but some consideration to risk is given in Italy, Portugal and Sweden. Funding is secured in some countries with ex-ante contributions and in some others with ex-post levies.

*Diversity of regulatory institutions*

A recent development is the establishment of universal regulators for banking, insurance and financial markets. This is the approach taken in the United Kingdom (in 1997), the Scandinavian countries (Norway in 1986, Denmark in 1998 and Sweden in 1992), and Japan. Let us describe the UK approach. The Bank of England Act (1997) sets up the Financial Services Authority (FSA) that integrates responsibility for the supervision of markets (securities), financial intermediaries and insurance. The FSA undertakes the authorisation and prudential supervision of all financial entities, the supervision of financial markets, regulatory policy, and the response to problems in institutions and markets that do not enter into conflict with the competence of the Bank of England on the stability of the financial system and systemic risk. The Bank of England and the FSA must work jointly, but each institution has a leadership role in its field of responsibility. The Bank of England, the FSA and the UK Treasury have signed a Memorandum of Understanding (MOU) that delineates their respective responsibilities. In particular, when dealing with an emergency situation: 'The Bank and the FSA would need to work very closely and they would immediately inform the Treasury, in order to give the Chancellor of the Exchequer the option of refusing support action' (MOU, par. 13).[14] It is specified also that the Bank and the FSA must share information and work jointly to avoid duplication in the gathering of information. The Bank of England has free and open access to supervisory records (MOU, par. 21).

In the EU, there are six countries in which the central bank is the main supervisory authority: Greece, Ireland, Italy, the Netherlands, Portugal,

[11] Other relevant Directives are that of investment services, (implemented in 1995), and those on own funds, solvency ratios and large exposures. The Directive on the Winding-Up of Credit Institutions was finally approved in 2001. It states that when a bank with branches in other member states goes bankrupt, the winding-up process will be governed by the bankruptcy proceedings of the home country.

[12] Furthermore, the legal obstacles to the setting up of subsidiaries have practically disappeared, although there are still restraints on the takeover of domestic institutions by foreign banks (need for approval by the supervisory authority and other restrictions in some countries).

[13] The harmonisation of minimum capital requirements may be needed to avoid the distortions induced by regulatory competition among national authorities. For example, undersupply of capital regulation may follow from the fact that national solvency regulations create a positive international policy externality on foreign lenders of domestic banks (see Sinn, 2003).

[14] At the same time some ambiguity about the character of the intervention is maintained: "The form of the response would depend on the nature of the event and would be determined at the time". (MOU, par. 12).

**Table 4.3**
**Supervisors of banking, securities and insurance in Europe, Japan and the United States (early 2002)**

| | Banking | Securities markets | Insurance |
|---|---|---|---|
| Belgium | BS | BS | I |
| Denmark | FSA | FSA | FSA |
| Germany | FSA | FSA | FSA |
| Greece | CB | S | I |
| Spain | CB | S | I |
| France | B/CB | S | I |
| Italy | CB | S | I |
| Ireland | CB | CB | G |
| Luxembourg | BS | BC | I |
| Netherlands | CB | S | I |
| Austria | FSA | FSA | FSA |
| Portugal | CB | S | I |
| Finland | BS | BS | I |
| Sweden | FSA | FSA | FSA |
| UK | FSA | FSA | FSA |
| Switzerland | BS | BS | I |
| Czech Republic | CB | SI | SI |
| Hungary | FSA | FSA | FSA |
| Norway | FSA | FSA | FSA |
| Poland | CB | S | I |
| Slovenia | CB | S | G |
| USA | B/CB | S | I |
| Japan | FSA | FSA | FSA |

**Notes:** CB = central bank, BS = banking and securities supervisor, FSA = single financial supervisory autority, B = specialised banking supervisor, S = specialised securities supervisor, I = specialised insurance supervisor, SI = specialised securities and insurance supervisor, G = government department.
The supervision of the securities markets is a generalisation of the most prevalent model in a certain state; it does not take the spread of the elements of supervision over different autorities into account.

Source: Lannoo (2002).

and Spain. These are the only countries in the EU-15 that maintain different supervisors for banking, insurance and securities markets. Germany[15] (2002), Austria (2002), Denmark, Sweden, and the United Kingdom have embraced the FSA model. Belgium, Finland, and Luxembourg have an integrated banking and securities supervisor. However, in Belgium, as well as Ireland, the central bank will take over and integrate financial supervision. France is the only country with a specialised banking supervisor, who shares responsibility with the central bank (see Table 4.3).

Overall, many central banks have moved away from banking supervision. However, as shown in Table 4.3, disparity still exists, and there are other contending models. For example, Australia has three supervisors with horizontally assigned tasks: systemic stability for the central bank, prudential supervision for a specialised agency, and conduct-of-business rules (disclosure, level playing field, transparency, market integrity) for another agency. In any case, it is to be noted that bank supervisors will focus on prudential supervision (control of credit and market risk), securities supervisors on investor protection and market integrity, while insurance supervisors will worry about the long-term sustainability of the insurers (and hence monitoring asset-liability management). Box 4.4 provides an analysis of the arguments in favour or against separation of regulatory institutions.

*The European regulatory and supervisory maze*

Supervision remains decentralised at the national level and national supervisors operate mostly within borders. The main institutional channel of the ECB for obtaining information regarding the banking and financial system is the Banking Supervision Committee of the ECB. The BSC also serves as an advisory body to the ECB when the latter forms opinions on EU and national legislation. It is in the BSC, where the national supervisors of EU countries (the central banks and other agencies) are represented, that the supervision of euro (and EU) countries must be co-ordinated via the exchange of information and co-operation of supervisors. It is worth pointing out that EU directives do not impose information sharing obligations on national supervisors in times of crisis. However, the so-called BCCI Directive of the EU has removed obstacles to the exchange of confidential information from supervisors to central banks. Moreover, there is bilateral co-operation between supervisors, who negotiate information exchange and supervisory procedures about cross-border activities in a Memorandum of Understanding (MOU). A more informal (and lower level) multilateral arrangement is the Groupe de Contact, a group of EU banking supervisors from the EEA (European Economic Area), which deals with individual bank problems. Parent to the Groupe de Contact is the EU Banking Advisory Committee (BAC) that has mainly a legislative role in advising the European Commission.

Parallel groups in insurance are the Conference of Insurance Supervisors and the Insurance Committee. In February 1999, a multilateral MOU among European security supervisors representing members of FESCO (Forum of European Securities

[15] However, the supervision of securities markets is in the hands of the Länder in Germany.

**Box 4.4**

**Optimal regulatory design**

*The central bank and supervision:*
Arguments for the central bank to have supervisory capacity. A central bank is best placed:

- to distinguish between problems of liquidity and of solvency in order to minimise the losses associated with loans granted and making possible a role as crisis manager;
- to determine the best kind of intervention (open-market or discount operations);
- to profit from economies of scope in the acquisition of information between the function of providing liquidity and that of supervising (for example, the first of these functions requires a detailed familiarity with the banks' liquidity requirements);
- to exploit synergies between the conduct of monetary policy and information collected with supervisory purposes. Indeed, banking supervisory information (early warning of problems with non-performing loans or changes in the lending pattern of banks) may improve the accuracy of macroeconomic forecasts.

Arguments against the central bank having supervisory capacity:

- The combination of control of monetary policy and the role of LLR at the central bank raises an inflationary concern. However, a central bank committed to price stability will sterilise the injections of liquidity necessary for the stability of the system in the event of crisis (as the Federal Reserve did in 1987) so that there is no undesired increase in the money supply. In practice matters may not be so simple and intervention as LLR may give rise to confusion in the expectations of the private sector regarding the central bank's monetary policy stance.
- There may be a conflict of interest between the reputation of the central bank as guarantor of currency and financial stability. For example, concern for the reputation of the central bank as supervisor may encourage an excessive use of the LLR facility so that bank crises will not put its supervisory capacity in question. Underlying the conflict-of-interest concern there are incentive problems among regulators related to their career concerns, accountability and monitoring of their multiple tasks, allocation of control, incentives to produce information and potential capture (see Vives, 2000).
- Some preliminary evidence indicates that central bank involvement in supervision may increase inflation (see Bini Smaghi, 2000, and Di Noia and Di Giorgio, 1999).

*The case for an independent FSA*
Arguments for the separation of supervision from the central bank:

- Separation facilitates the optimal provision of incentives to self-interested bureaucrats so as to minimise conflicts of interest.
- The convergence between the activities of financial institutions and markets points to the need for the combined regulation of banking, insurance and securities. It is becoming increasingly difficult to separate market-derived risk from credit risk. Banking crises that involve operations with financial derivatives (such as Barings or LTCM) seem to require specialised knowledge of market regulators. At the same time banking and insurance tend to converge.
- There are also EU-related political economy considerations. In a system in which the ECB is perceived as having already too much power and faces accountability questions, the creation of an independent regulatory agency may help lessen both concerns. It is easier to hold accountable an agency with a well-defined mission.

Commissions) was signed. The Lamfalussy Committee of Wise Men (see Section 4.3) proposed the creation of the Committee of European Securities Regulators (CESR) to replace FESCO and to strengthen co-operation among national regulators. The CESR was established in 2001. The Lamfalussy Committee also recommended the establishment of an EU Securities Committee with implementing powers to interpret and adapt legislation.

Additionally there are more committees in the EU. There is the Financial Services Policy Group (FSPG) to set strategic lines for financial services regulation, and the Economic and Financial Committee (EFC), which discusses financial stability and other issues in ad-hoc committees.

There are also some cross-sectoral committees: a Mixed Technical Group of Financial Conglomerates and a Cross-Sectoral Round Table of Regulators. The latter was set up to foster information exchange among supervisors following the recommendation of the Brouwer Report on Financial Stability by the Economic and Financial Committee.

The maze of committees is summarised in Table 4.4

### *3.3 Competition policy*

European competition policy also plays an important role in shaping the European financial architecture. Two important instances are bank rescues and state aids, and cross-border mergers.

First, the European competition policy Commissioner can intervene to examine whether a bank rescue with public money is compatible with competition policy towards state aids. Assistance to the French

**Table 4.4**

**The current structure of European supervisory and regulatory cooperation**

| Objective/ Sector | Banking | Insurance | Securities markets | Cross-sector and horizontal matters |
|---|---|---|---|---|
| Regulatory | Banking Advisory Committee (BAC) | Insurance Committee (IC) | Securities Committee | Finncial Services Policy Group (FSPG)<br><br>Mixed Technical Group on Financial Conglo-merates |
| Supervisory | Groupe de Contact | Conference of Insurance Supervisors | Committe of European Securities Regulators (CESR, formerly FESCO) | Cross-Sectoral Round-table of Regulators |
| Financial Stability | ECB's Banking Super-vision Committee (ESCB plus EU non-central bank supervisors) | | | Economic and Financial Committee (EFC), ECB's BSC |

Source: Lannoo (2002).

national champion Crédit Lyonnais was challenged exactly on this basis. Public rescue of Banesto (Spain) and Crédit Lyonnais provide additional examples of the Too-Big-To-Fail policy in Europe. European competition policy over state aids (complementing the EU Directive on reorganisation and winding-up of credit institutions 2001) allows prompt corrective actions. The intervention of the European competition policy authority may be desirable even if there are no negative cross-border externalities from the state aid. The reason is that the European competition policy authority may strengthen domestic policy makers' commitment to screen state aids according to market failure principles, away from local lobbying pressures.

Secondly, the European competition policy authority can play an important role in facilitating cross-border mergers and acquisitions by removing obstacles established by national authorities. Indeed, political obstacles to cross-border mergers have been pervasive – as suggested by the BBVA's failed attempt to take over Unicredito in Italy, or the problems of former BSCH (now SCH) in Portugal while attempting, and finally succeeding, in acquiring the Champalimaud group. In the latter case, the European Commission challenged the Portuguese regulator, who stated its opposition to the takeover because of "stability concerns". Another example is provided by the attitude of the French authorities, looking for a "French" solution in the triangular battle of BNP-SG-Paribas that ended with the merger of BNP and Paribas.

Responsibility for the control of domestic mergers, which are so far predominant in Europe, varies from country to country. In many countries, responsibility lies with the competition authority, sometimes shared with the regulator (United Kingdom, Switzerland, Scandinavia, France, Greece), but in practice the central bank/supervisor carries a lot of weight. In Italy, the central bank approves bank mergers and the competition authority has only a consulting role. European practice contrasts with that in the United States, where banking mergers must receive approval of the regulator (be it the Federal Reserve, the FDIC or the OCC) but the Department of Justice (DOJ) can (and does) challenge mergers that threaten to reduce competition substantially. Typically, the DOJ uses more stringent criteria.

## 4. Plans, reports, and problems

Several reports and studies on financial market integration in Europe, by the European Commission or by committees and groups specifically formed to address this issue, have pointed at several pending problems and have produced recommendations. In this section, we take stock of these concerns and add a few more.

### *4.1 Integration of financial markets: regulatory barriers*

As we have seen in Section 2, the integration of financial retail markets is far from complete. In addition to natural barriers (like language, culture, information), there are regulatory barriers. An important one is that the legislation on consumer protection is in the hands of the host country. Financial entities

still have to design 15 different products for 15 different markets (member states). This extends to e-banking. While the e-commerce Directive calls for the supply of services based on the rules of origin, in the draft of the Directive on distance selling of financial services things are much more complicated. Differential tax treatments are another obstacle to integration (as regards, for example, pension funds and life insurance).

Regulatory barriers are still in place as pan-European institutions are confronted with multiple rules and reporting requirements. For example, a typical large financial institution has to report to more than 20 supervisors in the EU (out of the 39 existing). To this we should add the political obstacles to cross-border mergers.

In 1998, the European Council adopted the Financial Services Action Plan for 1999-2005, comprising 41 separate measures (EU Directives and Commission Communications) with the aim of completing the legislative framework for market integration in financial services. Three main objectives are

- a single EU wholesale market,
- open and secure retail markets,
- state-of-the-art prudential rules and supervision.

There has been progress in the implementation of the 41 measures, but not without important setbacks. Examples of setbacks are the failure of the Take-over Bids Directive, the standstill on pension funds, and tensions between the European Commission, the Council and the Parliament in implementing the recommendations of the Lamfalussy Report (further discussed below in Section 4.3).

*4.2 Crisis management and cross-border risk: What framework?*

Under present arrangements, it is up to national central banks (NCB) to undertake the LLR function and provide emergency liquidity assistance to financial institutions. They are responsible for decision-making in crisis situations, and they have to bear the eventual cost of the intervention. So, if a bank develops solvency problems and ends up being rescued, the cost is paid either by the national deposit insurance fund or the national budget, or both. The responsibility for intervening falls on the "host" country central bank when a crisis hits a subsidiary and will be likely to be shared between home and host country central banks when it affects a foreign branch. If liquidity assistance has monetary consequences for monetary policy, then the ECB and the Eurosystem will be involved. Clearly, the involvement of the Eurosystem is to be expected in the presence of a general liquidity crisis, such as a grid-lock of the payment system. This policy is consistent with the principle of home country control for supervision and deposit insurance.

In response to criticisms that the present arrangements were not adequate to guarantee stability in the euro area, the Economic and Financial Committee of the EU was asked in 1999 to check "whether the existing regulatory and supervisory structures in the EU can safeguard financial stability". An ad-hoc working group chaired by Henk Brouwer was formed. In its Report on Financial Stability (Economic and Financial Committee, 2000) this group concludes that the existing institutional arrangements provide a coherent and flexible basis for safeguarding financial stability in Europe, and make some recommendations to enhance their smooth functioning. A second report of the EFC (Economic and Financial Committee, 2001) assesses whether the current arrangements for crisis management are appropriate, and whether any progress has been made on the recommendations of the first report. The report concludes: "Substantial progress is being made by the various supervisory committees and the national authorities in the EU in implementing the recommendations of the first report on financial stability."

The main recommendations of these reports are to enhance co-operation among different authorities (supervisors, central banks, and finance ministries), and to foster convergence of supervisory practices. Supposedly, these recommendations have been advanced with the help of a plethora of committees (see Section 3). To deal with major financial institutions (including conglomerates) domiciled in the EU, it was recommended to reach an agreement on one co-ordinating supervisor with well-defined responsibilities. Accordingly, the draft directive on financial conglomerates (April 2001) prescribes the mandatory appointment of one (or more) supervisory co-ordinator(s) of qualifying conglomerates as well as his (their) tasks.[16]

[16] Proposal for a directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

The key question is whether the existing co-operative framework of crisis management is up to the task of preserving financial stability in the euro area. To a large extent, the reason why present arrangements were considered adequate is that financial consolidation has so far taken place mostly at the domestic level. However, there are a number of open questions and issues regarding intervention policies in the event of the failure of some large financial entity, possibly causing systemic problems with cross-border spillovers in the euro area. A number of these questions are listed below:

- *The chain of command and crisis procedures.* Who is in charge of monitoring cross-border crises? Who will take the lead in a crisis with systemic consequences? What are the crisis management procedures at the ESCB? We have seen above that supervision is in the hands of NCBs. The response to a crisis is one of "improvised co-operation" anchored at the BSC of the ECB, where information should be exchanged and decisions taken. In response to concerns about the effectiveness of this arrangement, the BSC has developed a set of prudential indicators trying to capture aggregate risk exposures of EU banks. The goal of these indicators is that – should problems arise in, say, a large group, potentially leading to contagion effects in many EU countries – these problems are reported to the authorities in all the countries concerned (Economic and Financial Committee, 2001, p. 7). Similarly, the Brouwer Report II has requested national supervisors to add crisis management procedures to their bilateral MOU (as well as to remove the remaining legal obstacles to information sharing among supervisors).
- *Conflict between national supervisors in a transnational crisis.* Central banks and/or national supervisors may pay too little attention to problems of foreign clients of domestic banks, or to systemic international effects of a domestic crisis. For instance, in principle they could focus exclusively on the consequences of financial failure for the national economy, ignoring spillovers to other countries.[17] In addition, there is the possibility that the failure of a foreign bank will have systemic consequences in the host country.[18] Those conflicts of interest will likely impair information exchange among national supervisors.[19]
- *Excessive help at the country level and insufficient help at the European level?* National regulators may be pressured to help ailing national champions, while they may be less willing to help transnational banks (intervening too little and perhaps also too late). The issue is who will internalise the cost of failure of a pan-European bank given that any single country would not reap the full benefits of a bailout. Under the present rules it is not clear who would pay for a failed insolvent transnational institution that has gone bankrupt after being helped; that is, how would the losses be eventually shared among the fiscal authorities? Excessive help to national banks can be partially controlled by European competition policy (state aids). A low level of help to transnational banks has two sides: on the positive side it helps to keep moral hazard problems in check (see Box 4.3); on the negative side it may dangerously increase systemic risk.[20]
- *EU versus euro area.* Some thought should be given to the co-ordination issues between the euro area and the whole EU. This will be particularly important after enlargement.

### *4.3 Integration of securities markets: Regulatory fragmentation*

Despite many obstacles, some segments of the securities markets are integrating quickly in Europe. The formation of Euronext (the joint venture of the Paris Bourse and the Amsterdam and Brussels stock exchanges) is a positive example. The failure of the merger of the London Stock Exchange and the Deutsche Börse into iX (international exchanges) is a negative one. National regulation and lack of harmonisation in settlement systems, disclosure and supervision are obstacles to the integration of stock markets. The iX project illustrates the complexity of the arrangements devised to circumvent regulatory hurdles in different countries. According to the original plan, secondary-market trading on the pan-European blue-chip market was to be regulated by the UK FSA, while trading on the pan-European high-growth market was to be regulated by the German federal equities regulator (at the time BAWE). Furthermore, existing companies could

[17] For example, in the case of the failure of the Bank of Credit and Commerce International (BCCI), many of the clients were not residents of the country in which the bank was authorised to operate, that is Luxembourg, and hence the costs of failure were borne to a considerable degree by foreign clients or their insurers.
[18] Thus, for example, some local authorities in the United Kingdom withdrew their funds from small banks that had contracted risks with the BCCI.
[19] See Holthausen and Ronde (2001).
[20] The fact that national authorities cannot discriminate against foreign creditors in a winding-up process of a bankrupt bank (according to the Directive on the Winding-Up of Credit Institutions) may contribute to the undersupply of help to an international bank by the home country.

keep their home-country listing, while newly admitted companies would have been listed through the competent authority of their choosing. How to achieve settlement consolidation and a central counterparty system was, however, left vague in the merger proposal.

As mentioned before, the Lamfalussy Committee of Wise Men was set up to diagnose the regulatory mechanisms in the EU, and to propose measures to speed up the development of European financial markets. The report (February 2001) identifies a set of obstacles to integration of securities markets in Europe related to inadequate regulation (in addition to differences in legal systems, taxation, as well as political, trade, and cultural barriers). It also lists the most important gaps in European regulation and priorities for reform (see Box 4.5).

The major problem according to the Lamfalussy Report lies in the regulatory process because

- it is too slow (the Takeover Directive has been discussed for more than a dozen years and not yet been adopted, Basel I took 4 years, how long will it take for Basel II?),
- it is too rigid,
- it is too ambiguous,
- it fails to distinguish between core principles and implementation rules.

**Box 4.5**

**Lamfalussy diagnosis and priorities**

*Obstacles to development of European securities markets (p. 10):*

- The absence of clear Europe-wide regulation on a large number of issues (for example prospectuses, cross-border collateral, market abuse, investment service provision) which prevents the implementation of the mutual recognition system.
- An inefficient regulatory system.
- Inconsistent implementation, in part due to lack of an agreed interpretation of the rules that do exist.
- A large number of transaction and clearing and settlement systems that fragment liquidity and increase costs, especially for cross-border clearing settlement.
- The inadequate development of funded pension schemes in most Member States.

*The most important gaps in European regulation (p. 12):*

- Lack of commonly agreed guiding principles covering all financial services legislation.
- Failure to make the mutual recognition principle work for the wholesale market business in the context of the Investment Services Directive (ISD); for regulated markets themselves; for the retail sector; or for a single passport prospectus working for cross-border capital raising.
- Outdated rules on listing requirements, no distinction between admission to listing and to trading, and lack of a definition of a public offer.
- Ambiguity over the scope and application of conduct of business rules (Article 11 of the ISD) as well as on the definition of who is a professional investor.
- No appropriate rules to deal with alternative trading systems.
- Potential inconsistencies between the E-commerce Directive and financial services directives.
- No comprehensive market abuse regime.
- No cross-border collateral arrangements.
- No set of common European-wide accepted international accounting standards.
- Outdated investment rules for UCITS and pension funds.
- Unresolved public policy issues for clearing and settlement activities.
- No agreed takeover rules.
- No high and equivalent levels of consumer protection and no efficient methods for resolving cross border consumer disputes.

*The main priorities for reform (p. 13):*

- A single prospectus for issuers, with a mandatory self-registration system.
- Modernisation of admission to listing requirements and introduction of a clear distinction between admission to listing and trading.
- Generalisation of the home country principle (mutual recognition) for wholesale markets, including a clear definition of the professional investor.
- Modernisation and expansion of investment rules for investment funds and pension funds.
- Adoption of International Accounting Standards.
- A single passport for recognised stock markets (on the basis of the home country control principle).

The Lamfalussy Report proposes a four-level approach to securities market legislation:

- definition of a framework legislation (for example directives setting the general principles);
- establishment of an EU Securities Committee with implementing powers to interpret and adapt legislation;
- creation of the Committee of European Securities Regulators (CESR, done in 2001), replacing FESCO, to strengthen co-operation among national regulators; and
- adoption of stricter enforcement procedures.

The creation of the EU Securities Committee was contested by the European Parliament (EP) on the

matter of the degree of implementation powers of such a committee ("institutional balance" in European parlance). But even independently of political and institutional issues, the approach envisioned by the report is not easy to apply. This is because it is not obvious how principles should be distinguished from implementation rules. For example, the draft prospectus[21] and market abuse[22] directives have gone into quite a bit of detail. The EP has proposed more than 100 amendments to the market abuse draft proposal (because the EP would not be able to amend the "implementation" decisions of the Securities Committee at a later stage). It is to be expected also that enlargement of the EU will compound this kind of problem.

The Lamfalussy Report has contributed to what is called (in European parlance) the "comitology" procedure. According to this procedure, while directives establish general principles, adopting the implementation and adaptation procedures of the general principles is left to a committee with broad interpretative powers (the "comitology powers") – an example being the proposed EU Securities Committee. This has clearly clashed with the desire of the EP to retain control over the process, but eventually the EP settled on the proposal, in exchange for the promise that the Commission would take "utmost account" of its views. We note here that the Commission had already promised not to go against the predominant views of the Council as regards key implementation issues. The EU Securities Committee is chaired by the European Commissioner in charge, and takes decisions by qualified majority voting. Its decisions are prepared by the independent Committee of European Securities Regulators (CESR, see Table 4.3).

But as regards the implementation of the revisions of the 1988 Basel Capital Accord (see Box 4.6), an empowered Banking Advisory Committee (BAC) could end up having a similar role as the EU Securities Committee. Both will be in charge of interpreting and adapting the EU directive that establishes the framework for the application of Basel II.

The Giovannini Group was formed in 1996 to advise the Commission on financial integration.

[21] The draft prospectus directive requires that member states decouple listing from trading and to have the listing authority as an independent supervisory agency.
[22] The market abuse draft proposal requires that member states appoint one independent authority to deal with insider trading.

**Box 4.6**

**Basel II**

Basel II will reform the 1988 Basel Accord on Capital Requirements to adjust them better for risk. Capital requirements, supervision/intervention and market discipline/disclosure are the three pillars of regulatory reform. As regards capital requirements, banks have two options. The first (standard approach) consists of relying on credit rating by external agencies to set the risk weights for different types of loans (say corporate, banks and sovereign claims). The second consists of relying on internal rating: banks themselves estimate probabilities of default, and assess the loss given default in an advanced version of the method. The idea is to calibrate the capital requirement so that it covers the Value at Risk from the loan (expected and unexpected losses from the loan) under some appropriate set of assumptions. The implementation of Basel II will require a complex and technical directive (given that a lot is at stake for financial institutions).

The latest report of the group concentrates on existing problems in cross-border clearing and settlement in the markets for fixed-income securities, equities, and exchange-trades derivatives. The group has proposed that systems should be judged against criteria of cost efficiency, accessibility, and safety and soundness.

Two recent initiatives of the European Commission deserve to be mentioned. The first is a proposal concerning regulation of listed companies – the so-called single European prospectus. The second proposal is about allowing investors to by-pass stock exchanges.

The proposal for a single European prospectus, agreed in November 2002 by EU finance ministers, but still to be approved by the European Parliament, allows securities (equity and bonds) to be issued with a single prospectus approved by the home regulator. A listed company, for example, would be regulated by the authorities of the country where the stock exchange is situated. The same applies to bonds under a value threshold. This is consistent with the "home country principle" in financial supervision and is designed to help firms raise capital with a single document. Once approved by domestic regulators, the "prospectus" (or main document for listing) has to be accepted by all EU exchanges. However, Germany and the United Kingdom would prefer to let companies choose the listing authority by which to be regulated. Freedom of choice corresponds to current practice.

Very recently, in its proposal for an Investment Services Directive, the European Commission has envisaged scrapping the rules forcing investors to trade only via stock exchanges. Investment banks would be allowed to compete with stock exchanges by trading shares for their clients in-house, disclosing prices before the market.[23] Investment banks would also be able to operate across the EU when authorised in their home country. The idea is to allow investors to by-pass stock exchanges and trade directly via investment banks so that regulatory fragmentation of stock exchanges would not prevent cross-border trade. At present, banks are already allowed to trade in-house in some countries such as the United Kingdom and Germany, whereas in other countries such as France, Italy and Spain all major trades have to go through the organised stock market. Large investment banks and stock exchanges (like London and Frankfurt) are to benefit from these measures while smaller banks and national exchanges may suffer. The evaluation of such a proposal comes down to gauging the trade-off between more competition, enhanced by the rivalry between investment banks and exchanges, and the decrease in liquidity in stock exchanges as well as the lack of transparency of in-house trading. At first blush, the proposed measure seems to accept defeat conceding that the emergence of integrated European stock markets is difficult despite the fact that markets are superior precisely in price discovery and facilitating transactions.

## 5. European financial architecture: diagnosis and proposals for reform

### *5.1 Diagnosis*

*Potential increase in risk*

The introduction of the euro implies the consolidation of deep and liquid financial markets in the euro area as well as in the EU. As financial integration advances, it is likely that the relative weights of financial intermediaries and markets in continental Europe will shift towards the latter. Deeper and more integrated markets increase diversification possibilities, but at the same time raise potential problems of contagion and liquidity crises. Indeed, as European financial markets become integrated, cross-border externalities increase: the failure of an institution in one country may have effects on the financial system of other European countries. This may happen either because of default in interbank commitments, or via problems in the payments mechanism.

Furthermore, credit risk may increase in the national economies because the exchange rate and monetary policy buffers are no longer in place (although diversification possibilities may increase and exchange rate risk eliminated in the euro area). At the same time, stronger competition will impinge upon the restructuring of the banking sector creating difficulties for weak institutions and/or enhancing the incentives for banks to take more risk. The exposure of European banks to emerging markets may be an example of the latter. It is even questionable whether the recent wave of domestic mergers adds to stability. This is so because enhanced diversification possibilities (which are relevant given the diversity of regions inside European nations[24]) through consolidation might be more than compensated by the perverse incentives induced by the TBTF policy applied to national champions. Note that, to the extent that regulatory and political obstacles hinder cross-border consolidation, they end up exacerbating this problem. Overall, these considerations lead us to conclude that the fragility of the banking system may well increase in the short term.

*The consequences of regulatory fragmentation*

Regulatory fragmentation in Europe is a major obstacle to financial integration. It reduces the international competitiveness of European markets and institutions, and poses a threat to the stability of the financial sector. There is a wide consensus on the first and second issue (as clearly shown by the Lamfalussy and Giovannini reports). It could be argued that Europeans should not be too concerned with the stability of the financial sector, precisely because European financial markets remain segmented. Indeed, one may interpret the statements of the European Commission and the ESCB along this line. For example, the Brouwer Report (2000) on financial stability concluded: "The existing *institutional* arrangements provide a coherent and flexible basis for safeguarding financial stability in Europe. No institu-

[23] In a first proposal, the European Commission allowed investment banks to disclose prices afterthe trade was conducted.

[24] See Danthine et al. (1999).

tional changes are deemed necessary." However, capital markets are integrating steadily. Although it is true that the retail business remains segmented, changes may happen relatively fast (with the expansion of electronic banking, for example).

*The role of disclosure and market discipline*

It has been argued that disclosure requirements and market discipline are a substitute for financial architecture design.[25] For example, in the present decentralised supervisory framework, an increase in disclosure by financial intermediaries would contribute to increase market discipline and reduce information asymmetries among European supervisors.[26] The LTCM crisis provides a paradigmatic example: If the banks that had lent to LTCM had declared their positions, then supervisors and market agents could have acted upon it. However, relying on transparency and market discipline alone is not without problems. First, more transparency may increase, rather than decrease instability.[27] Second, a problem of relying on market discipline is that agents, small investors in particular, have an incentive to free-ride on the information generated by others on financial institutions. [28]

*5.2 Thinking ahead*

*Crisis lending and crisis management in the euro area*

The present system of "improvised co-operation" in a crisis situation may not be adequate and put the stability of the system in danger. The value of centralised authority with appropriate information is enhanced in crisis situations. This responsibility for stability can only be assumed by the ESCB and the ECB in particular.

The ESCB should explicitly assume the function of guarantor of the system.[29] This would probably only require a broad interpretation of the Treaty (Article 105(2 and 5)) on the contribution of the ESCB to the smooth operation of the payment system and the stability of the financial system. At the same time the ESCB should establish and make public a formal framework of crisis resolution. The chain of command in a crisis situation should be clearly identified. Duisenberg's declaration of October 1999 in the European Parliament, on the division of responsibilities between national central banks and the ECB, is a step in this direction but what is to be done with transnational institutions should be clarified.

By leaving open the resolution of the many problems raised by the presence of transnational financial institutions, the present system imposes discipline (controlling moral hazard) at too high a cost in terms of systemic stability. An explicit recognition of the role of the ECB could instead enhance the response to systemic financial stability concerns, counting on the ECB's reputation not to create moral hazard problems (due to expectations of excessive help). The ECB should be able to develop such a reputation given its strong credentials. The formal recognition of the role of the ECB as a lender of last resort is not in contradiction with maintaining a degree of "constructive ambiguity" about the circumstances of intervention. Indeed, transparency in the procedures to follow in crisis situations provides a reference point for the markets, and minimises costly bargaining ex post among authorities. It also provides a decision-making framework that should guarantee fast responses, with clearly defined responsibilities for the different institutions involved.

Crisis lending cannot be separated from fiscal issues when liquidity problems end up in insolvency. When this happens to a transnational financial institution, a procedure must be devised to share the fiscal costs of the intervention. A formal mechanism of co-operation should be established between the ECB, the NCBs and/or national supervisors, and the national treasuries to clarify responsibilities, establish information sharing protocols, and elucidate who would pay for failed (insolvent) institutions that have been helped. The European Union Council of Finance Ministers (Ecofin) could have a consultative role when the ECB initiates interventions that may end up in losses to be paid with tax money. This proposal is in line with the idea launched in April 2002 by Mr. Eichel of Germany and Mr. Brown of the United Kingdom to establish a "European stability forum".

[25] See Favero et al. (2000).
[26] This is inspired by the New Zealand experiment where quarterly disclosure of relevant bank information is mandatory and there is no deposit insurance. A system of penalties, including the possibility of unlimited civil liability of banks' directors for loses caused to creditors, enforces the disclosure requirements. See Mayes (1997) and Mayes and Vesala (1998).
[27] See Rochet and Vives (2002).
[28] New Zealand's reliance on market discipline to control risk has the particularity that most banksare foreign and therefore supervised abroad.
[29] This has been argued by Chiappori et al.(1991), Vives (1992) by Folkerts-Landau and Garber,(1994), and more recently by Pratti and Schinasi(1999).

*Supervision and political economy*

The review of supervisory arrangements in Sections 3 and 4 points to the need for more centralised supervision mechanisms in order to internalise cross-border effects and foster financial integration. In an integrated market the mere co-ordination of financial supervision may prove insufficient. The question then is how to devise a supervisory system for the euro area (as well as the EU at large) that promotes financial integration and the competitiveness of European institutions and markets, while at the same time guaranteeing financial stability in a long-run perspective.

There are at least two alternative models, apart from the current decentralised arrangement. In the first model prudential supervision of banks is in the hands of the ESCB with the ECB having a central role while European-wide specialised regulators in insurance and securities are constituted. In the second model, an integrated regulator of banking, insurance and markets – a European Financial Services Authority (EFSA) – is formed, while the ECB (in the ESCB) is responsible for systemic problems.

In either model it must be noted that the lender of last resort function would require the ECB to have some monitoring powers. This concerns in particular the power to access supervisory records and gather information. This seems possible without amending the Treaty of the EU. A central bank in charge of systemic stability needs access to supervisory information. For instance, suppose that facing a major threat to financial stability and lacking supervisory capacity, the ECB will have to base its actions on information provided by national authorities. Not only might national authorities be tempted to under-report problems; greater access to information for the ECB would save costs in communication and negotiation, as well as facilitating the exchange of information.

The first solution centralises supervision of banking in the ECB, but maintain the implementation in the decentralised structure of the ESCB. This solution would probably be favoured by the ECB, but disliked by the NCBs and national governments. The attempt at the Nice EU summit to enlarge the supervisory responsibilities of the ECB failed because of pressure from NCBs. (It was proposed but not accepted to extend the majority voting decision procedure to the article in the Treaty of the EU that envisages a larger role of the ECB in banking supervision.)

As regards the establishment of a European Securities and Exchange Commission as a supervisory body for European financial markets, the EU Securities Committee proposals in the Lamfalussy Report could be seen as a first significant step in this direction. But the main message of the Lamfalussy Committee is that a lot of preliminary harmonisation work among the different national authorities remains to be done in such disparate areas as legal frameworks, surveillance of settlements systems, disclosure, and enforcement. The challenge is to develop a common framework that allows different market institutions and trading systems to compete.

The case for a European Financial Services Authority (EFSA), with authority over banking, insurance and securities, is based on the trend toward integration of intermediaries and market operations, which makes it increasingly difficult to separate credit and market risk. Such an independent agency would bring relief also to the potential conflict between monetary policy and supervision of the financial system. The EFSA could have a horizontal structure with one division in charge of prudential supervision (monitoring credit and market risk), and another in charge of investor protection and conduct-of-business rules. An alternative model could have three divisions for banks, insurance companies, and markets, but then the synergies of working with well-defined objectives might be lost.

Political-economy considerations indicate that an independent EFSA, along with the ECB itself, might better resist local pressure to assist particular institutions. In principle, an EFSA would facilitate accountability, as both the ECB and the EFSA would then have well-defined missions, and would not increase the power of the ECB, which is already perceived as very powerful. However, note that such an agency would face the same accountability problem as the ECB, namely the lack of a well-defined European political principal.

In either of the two models, supervision need not be completely centralised at the European level. First, because national supervisors will need to be involved in the day-to-day supervisory operations.

Second, because a two-tier system with some scope for regulatory competition can be envisioned because European level agencies could leave entities trading mostly within one national jurisdiction to be supervised by the appropriate national regulator (under the home-country principle).

Neither an EFSA nor centralisation of supervision at the ECB level are proposals for the immediate future. The first would require a Council decision, the second a change in the Treaty of the EU. However, an open debate about this long-term aspect of European financial architecture is needed as well as leaving the door open in the Convention on the Future of Europe for the necessary institutional changes to implement more centralised regulation.

## List of abbreviations

| | |
|---|---|
| BAC | Banking Advisory Committee |
| BAWE | Bundesaufsichtsamt für Wertpapierhandel |
| BBVA | Banco Bilbao Vizcaya Argentaria |
| BCCI | Bank of Credit and Commerce International |
| BNP | Banque Nationale de Paris |
| SG | Société Générale |
| BSC | Banking Supervision Committee |
| BSCH | Banco Santander Central Hispano |
| CB | Central Bank |
| CD | Certificate of Deposit |
| CESR | Committee of European Securities Regulators |
| DOJ | Department of Justice (US) |
| ECB | European Central Bank |
| EEA | European Economic Area |
| EFC | Economic and Financial Committee |
| EFSA | European Financial Services Authority |
| EP | European Parliament |
| ESCB | European System of Central Banks |
| EU | European Union |
| FDIC | Federal Deposit Insurance Corporation |
| FESCO | Forum of European Securities Commissions |
| FRB | Federal Reserve Board |
| FSA | Financial Services Authority |
| FSPG | Financial Services Policy Group |
| IC | Insurance Committee |
| ISD | Investment Services Directive |
| LCTM | Long-Term Capital Management |
| LLR | Lender of Last Resort |
| M&A | Mergers and Acquisitions |
| MOU | Memorandum of Understanding |
| NCB | National Central Bank |
| OCC | Office of the Comptroller of the Currency |
| SCH | Santander Central Hispano |
| TBTF | Too Big to Fail |
| UCITS | Undertakings for Collective Investments in Transferable Securities |

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