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Which Model for Prudential Supervision in the EU? Comments on Danièle Nouy, "Ensuring Financial Stability through Supervisory Cooperation"

The starting point for a discussion of the topic seems clear: A fragmented system of national supervision would not deliver a good safeguard against financial instability in the face of deepening integration in the EU. Supervisory cooperation has been developed in the EU for some time already, and Danièle Nouy's presentation describes very well how the Committee of European Banking Supervisors (CEBS) has taken further impressive steps in a short period of time towards – what she labelled as – "… a more formalised, and very efficient banking supervisory framework: some kind of EU decentralised model". A large part of the new activity has been associated with the pressing needs to step up cooperation related to the implementation of the Basel II rules in Europe.

While a lot has been already done, many important questions seem to deserve further attention as regards supervisory convergence and alloca-

tion of supervisory powers. I will discuss, first, the basic models to develop the EU supervisory structure, and, second, some key specific issues.

Problems of Fragmented Supervision

It is useful to recall at the outset the main problems of uncoordinated national arrangements when there is deeper integration and significant cross-border institutions. They are twofold from the perspective of optimal institutional design:[1] First, there are questions about the effective supervision of cross-border institutions, when the incentives and interests of home and host authorities could be misaligned (barring any questions of resources). Second, spill-over effects (externalities) of a crisis on other countries may not be duly observed.

In theory, two solutions can be envisaged: Designing an appropriate "contracting" mechanism among supervisory authorities ("an EU supervision model"), or establishing a supranational European supervisory authority for large cross-border institutions.

Discussing the modalities of the second solution – e.g. whether to have an ESCB-type of a system, or a single institution – is beyond the scope of this brief paper. It would solve the above two problems of institutional design more neatly than the first solution, but arguments against have also been presented. In my view, the case for a European authority will become stronger with the emergence of a larger number of pan-European institutions, but it will be feasible only in the long run due to many unresolved, for instance legal issues.[2]

Hence, a practical and immediate solution continues to be based on national competence. In what follows, I will discuss two alternative models: "lead supervision" and "a network of competent supervisors". Fragmented, weakly cooperative model is not feasible. As Danièle Nouy put it: "For the CEBS and EU national supervisors, it is a succeed or perish situation".

In evaluating the models, the crucial issues from the financial stability angle are again: ensuring effective supervision of cross-border institutions, and providing for effective crisis management. I think that, here, a crucial and unavoidable question is: Who picks up the bill when a systemically relevant entity in the host country runs into trouble?

Model 1: "Lead Supervision"

Cross-border institutions are strongly behind a "*lead supervision model*", under which the home country (lead) supervisor is responsible for prudential supervision (capital adequacy and liquidity) of the whole group and all its entities irrespective of their legal status (subsidiary or branch). The lead supervisor would decide autonomously on the supervisory measures and reporting requirements, both at the group and local level. In the purest form, there would be limited role for the host authority even to obtain

[1] *An analysis of these issues can draw on the economics of mechanism design (see e.g. Milgrom and Roberts, 1992). These insights can be used to analyse the incentives and interests of home and host authorities to promote the overall "European good". See further discussion in Enria and Vesala (2003).*

[2] *See e.g. Schoenmaker and Oosterloo (2005); and Schilder and Knot (2005).*

information (as often already the case in foreign branches).

The model would imply a transfer of the current formal responsibilities of the host authorities with respect to the solo-supervision of subsidiaries to the lead supervisor. With respect to branches (and "European Company banks" operating via cross-border branches), such a model is already embedded in the EU framework, as the formal responsibilities of the host authorities are very limited.

The lead supervision model is in line with the concept of an EU internal market and would reduce the burden of international institutions. But does it best ensure effective supervision of cross-border institutions, or is it in line with national crisis management arrangements?

I take the second issue first. Consider a solvency crisis in a cross-border bank. There will be negotiation between the home and host ministries of finance. Even if all depositors were protected by the home country deposit guarantee system, it would be very difficult for the host country to allow an unorderly failure of the bank, if the bank made up a substantial part of the host country's banking system. In the case the bank is not systemically important and is "replaceable" in the home country, the conflict of interest would be strong and the host country would have to consider alone some sort of a rescue operation (likely trying to confine it to the local activities of the institution). If deposit guarantee funds were not sufficient, there would be pressure on the host country to protect local small savers as well.

Hence, there can be host country public money at stake, while there would be no corresponding supervisory competence in the lead supervision model. It can be considered illogical that a country could be obliged to pay for a crisis in an institution that is not under any supervision of that state. Moreover, the academic literature sees the basic rationale of prudential supervision as preventing the excessive risk taking (moral hazard) incentives arising from the special public safety net extended to banks. Clearly, it is in the host country's vital interest to have available preventive supervisory measures, e.g. demand higher level of capitalisation in order to reduce the risk of failure. In the EU, one can much rely on the competence of the home supervisor, but it would be inappropriate to leave the host supervisor without any role.

The pure lead supervision model could entail problems concerning the effective supervision of cross-border groups as well. For example, the home authority might put less importance on supervising the foreign activities of a financial institution or group (or even the whole group) than the host authority would wish – especially if the institution were more important for the host market than the home market. Such cases can be envisaged in reality. In turn, the host authority may lack incentives (or ability) to deliver relevant information to the home authority, as the host authority is not responsible for the overall consolidated supervision (or has shortage of information). Host supervisors can, for instance, monitor the areas of growing risks in their markets and make cross-institution comparisons, which can be important for assessing the overall risk profile of the institution in question.

Model 2: "A Network of Competent Supervisors"

A model of *"a network of competent authorities"* entails effective home-host

cooperation and maintains an active role also for host authorities, especially if foreign entities are of systemic relevance in the host country. The first main element of the cooperation is effective exchange of information in both ways: From home to host on the overall condition of the cross-border institution – frequent ongoing information and timely information in times of stress – and from host to home on the risks accrued in local markets. The second main element is the effective allocation of operational supervisory tasks between the home and host.

The network model would allow observing financial stability concerns in all Member States better than in the lead supervision model, and would ensure the host input to the overall supervisory process of cross-border institutions. This approach could also be actually favourable to further integration as it could prevent protective host country policies motivated by financial stability concerns. Finally, it could entail a lower risk of supervisory arbitrage (as long as supervisory convergence is incomplete). The risk of supervisory arbitrage could become larger in the future as the European Company Statute allows an easy transfer of corporate seat in the EU.

A controversial point is whether the role of the host supervisors should be recognised in case of major cross-border branching operations (like now in the case of subsidiaries). In my view, the stark distinction in the original EU legal framework between subsidiaries (host responsibility) and branches (home responsibility) should be diluted. First, the risks and significance of host market businesses can be very similar in both cases, and the group can in both cases have substantial centralisation in internal organisation and risk management.[3] Second, a move to a European Company form by major cross-border banks can result in systemically relevant branches, entailing a legitimate host country financial stability concern and possible crisis management and financing responsibility, which should be combined with available, preventive supervisory tools.[4] Such cases were not envisaged when the Single Market legislation was crafted.

Efficient Solution: Coordination by the Home of the "Network"

The network model is less streamlined and more burdensome for international institutions than the lead supervision model. However, duplications should be avoided through close coordination between the home and host authorities (e.g. joint supervision plans and common reporting structures), full information exchange, and further convergence at the EU level of supervisory requirements.

To support an efficient supervisory process geared to monitor the overall condition of cross-border institutions, the overall coordination responsibility should be clearly allocated to the home authority, also as regards subsidiaries. Developing the network model in this way could be the most balanced way to proceed towards "European supervision". It would obtain the efficiency benefits of the lead supervision model,

[3] *The main difference is that the host country might be able to ring-fence the liquid and sound assets of a subsidiary, and – at the same time – prevent their use to stabilise the condition of the entire group.*

[4] *If Nordea turned into a European Company, a cross-border branch would cover 30% to 40% of the Finnish banking market depending on the product. Such cases could emerge also elsewhere, e.g. in the new Member States.*

while preserving the financial stability benefits of the network model. Supervisors can still work a great deal to enhance the efficiency of supervisory cooperation. The principles of home-host cooperation and the consistent reporting frameworks (COREP and FINREP) being developed by the CEBS are very helpful to avoid duplications and to reinforce cooperation and information exchange.

Refinements to the Model

There are several issues, which will need further consideration when developing the model of supervisory cooperation. I will address a few of them in the interest of discussion.

First, there is a tricky issue of final *decision-making power:* Whether it should rest with the coordinating home supervisor, or with the full "college" of home and host supervisors of a cross-border institution? In any case, host authorities should be able to participate in decision-making, especially if there were (legal or de facto) host country crisis management responsibility. For instance, there could be an agreement that the home authority should consult the host authorities on major supervisory measures that would be adopted on the whole institution.

Cooperation among supervisors will likely proceed in good spirit in most of times and without really the need to have the coordinating supervisor to decide at the end. But what to do when the "college" strongly disagrees, or a host country has a vital issue at stake? If a mediation mechanism lacked within the supervisory community, the host supervisor might have to turn to its local ministry and demand negotiation with the home country.

To resolve issues among supervisors themselves, one could consider developing a *mediation function* at the EU level under the auspices of the CEBS. This option faces the problem that the CEBS cannot issue legally binding decisions upon national supervisors, but it could exert effective "peer pressure" on its member institutions.

Second, one could think that cooperation among authorities could be effective without explicit agreements. But, in light of economic theory, relying on "implicit agreements" may not guarantee a good outcome. Namely,

when actions are not observable and information is asymmetric – such as supervisors' activities and information – the parties to such an implicit contract may choose to pursue their own private interests. For instance, the home authority may be reluctant to reveal unfolding problems in an institution to other authorities, because it may fear that widespread knowledge gives rise to the risk of adverse market reactions. This may not leave sufficient time for the host authorities to assess the actions needed to preserve their local financial system stability.

To avoid this type of problems, *explicit ex-ante agreements among authorities* (i.e. MoUs) can be used to clearly delineate each others' responsibilities and clarify expected behaviour. The CEBS might promote the principle that explicit MoUs underpinning supervisory cooperation should be further developed to allocate supervisory duties. They should also contain binding requirements (possibly even

trigger points) and time frames for information exchange and consultation in times of crisis.

The agreements could also benefit from *standardisation* by making the further development of the bilateral relations more agreeable to all authorities, since it would allow for *reciprocity*. For example, an authority might not provide information to another supervisor if a third authority does not agree to behave in the same way under similar circumstances.

Third, agreements among authorities could be effective without any legal obligation under the EU legislation governing supervisors' cooperation and convergence, provided that there is some other mechanism in place to *check and enforce compliance* with the agreements (see e.g. Padoa-Schioppa, 2004, chapter 7). Irrespective of any formal mechanisms, "reputational penalties" as a result of a breach of widely known agreements may be higher under a system where there is explicit pre-commitment and strong *peer review* among authorities.

The disclosure framework for supervisory authorities' decisions and regulations – being developed under the leadership of Danièle Nouy – can go a long way towards fostering the *peer review*. Other activities and instruments might also be devised to this end. The CESR has considered, for instance, the use of "mission teams" to collect information about possible inadequate convergence or cooperation.

Fourth, the CESR has concluded that supervisory convergence can take place effectively only if the relevant authorities have *equivalent and adequately strong powers* to supervise and sanction institutions. It might be worthwhile to investigate whether differing legal powers of supervisors is an obstacle to further convergence also in the prudential supervisory field.

Fifth, strengthening of the coordinating role of the home (lead) authority might need *changes in EU legislation*, as well as apparently creating of an adequate role for the host authorities vis-à-vis foreign branches of systemic relevance. Such legal changes could be needed to back up home and host authorities' activities, clarify industry's expectations, and support CEBS' further work in developing supervisory cooperation. If unaltered, the EU legal framework could even constrain supervisors' cooperation, which should not be the case. In addition, supervisory cooperation may not be equally effective across the EU to prevent competition in supervisory laxity and supervisory arbitrage, unless its main features are stipulated in the EU legislation.

The EU legislation should then probably make a distinction between significant and non-significant subsidiaries and branches. This might be left to home and host supervisors' judgement, based on a list of elements of significance.

Finally, the *consistency of supervisory and crisis management* arrangements is a key issue, as discussed above. Such inconsistencies could also constitute obstacles to integration. To this end, the CEBS has started useful work as regards cooperation among supervisors and other relevant authorities, and will advise the European Commission on a needed reform of the EU deposit guarantee arrangements.

Concluding Remark

I have discussed issues related to cooperation among supervisors with hindsight to the core point that efficient banking supervision is the main policy instrument to safeguard financial stability – as clearly embedded in Danièle Nouy's presentation.

Banks' weakness and failure can lead to financial instability (i.e. systemic risk) through contagion via interbank credit, payment system or market exposure links between banks. But recent very interesting research conducted here in Austria has shown that the exposure of many banks simultaneously to common external shocks may be a more predominant risk to financial stability than contagion from single bank failures.[5] Monitoring such common exposures is the very important macro-prudential aspect of financial stability surveillance. It is and should be developed in cooperation among central banks and supervisors, bringing together information of banks' exposures in various economies and markets with the potential macroeconomic and financial market sources of risk. At the EU level, the Banking Supervision Committee and the ECB conduct very valuable work in analysing the stability of the EU banking and financial system and pooling together information from national sources. ❧

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[5] *See Elsinger et. al. (2004). A recent study by Gropp and Vesala (2004), obtained similar results for a set of EU banks.*