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## *The New European Banking Supervision Infrastructure*

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**Abstract:** *In the light of the recent events, the need for an integrated supervision at European level became obvious, both for the better management of the crisis and for the efficient prevention of such negative events in the future. The European integration process has provided the incentives for the development of pan-European networks by the banks from the European Union. In this context, the contagion risk has grown exponentially and thus the need for a new European supervision framework of the European banking sector has become more than obvious. In this context, the aim of our paper is to present the main theoretical concepts regarding an efficient pan-European supervision framework of the banking sector and also the main evolutions that have occurred in the last years. To achieve this we have reviewed the main academic literature on this subject, this approach allowing us to characterize the current banking supervision framework and also project future evolutions.*

**Keywords:** *supervision system, European banking sector, European integration, financial crisis.*

### **Introduction**

Prudential supervision of banking activities is justified because banks have access to the general public savings. The aim of the supervision and regulatory authorities is to allow banking institutions to have access to the general public savings only when the risk of default of these institutions is low. Most of the time in history, in the case of turbulences in the banking activity, the governments have intervened with tax payers money in order to raise the liquidity of the banks. This is the reason why the regulations regarding the capital adequacy of the banks are representing the essence of the whole regulatory process. Also, this is the reason why, at least until the start of the financial crisis, the responsibility of the banking prudential supervision was exclusively delegated to local authorities of each member states of the European Union.

In the case of the European Union, banking institutions that are active in more member states must comply to a great extent to the regulatory measures that exist in those states, despite an ample convergence process and the adoption of several European directives that aim at reducing the heterogeneity of the environment. Thus, a banking institution that operates in all the European Union member states will have to answer to the requests of over 50 regulatory and control institutions. To this, we must add that the activity of this institution will be consolidated, supervised by a comity lead by the regulatory and control authority from the home state of the bank. This supervisory system, despite the undertaken modifications as a result of the 2007 crisis, is still very complex and hard to follow and prevents the manifestation of constructive synergies that should appear in the context of pan-European businesses. In some cases the national regulatory framework of some states are not just incompatible but contradictory, which tends to determine the possibility of arbitrage or even conflicts between the different national regulatory authorities. The situation can be even more complex if the banking group decide to integrate its operations on more markets, organising some of its departments at group level. In this case, a regulatory authority from one states where the banking group operates cannot understand the situation of that institution except if they have a full imagine of all the operations. If each of the national supervision authorities has its very own independent idea on the situation of a banking group that operates at pan-European level, this can lead to fundamental divergent opinions between national regulators. This can have a direct impact not only on the cost of the banking institution but even on its financial stability and safety.

In the case of a financial crisis, like the one from 2007, there will be a total chaos because of the different banking refinancing schemes that pan-European operating banks are face with in every member country in which it operates, as Treasuries and Central Banks from different states should be involved. Still, as a result of the recent financial crisis a series of measures were taken in order to avoid the reappearance of such situations and to coordinate efforts inside the European Union in this type of matter. The changes were based on the mutations that took place in the European banking environment. The measures undertaken have come to complete the existing legislative framework that has been set up through the following directives:

- the European Union Capital Adequacy Directive has created a level playing field regarding the capital ratio that the banks must have if they operate in the European Union;
- also this directive establishes that the main supervision authority has the ability to approve specific risk management models both for the whole banking group, but also for each subsidiary and branch that is active in any European Union state;
- in addition, the supervision authorities, the central banks and the treasuries of the member states have all signed a memorandum for common action in case of a new financial crisis;

Exactly the existence of an insufficient integrated framework at the European level has made the response of the European authorities to the financial, economic and severing debt crisis hesitant and especially national driven. Taking into account these aspects and the devastating effects that the financial and economic global crisis had on the European economies, the development of the new European Supervision Authorities for the financial sector and the enhancement of their attribution are the natural next steps in order for the creation of an efficient supervision and control system at in the European Union.

In this context, the aim of our paper is to present the main theoretical concepts regarding an efficient pan-European supervision framework of the banking sector and also the main evolutions that have occurred in the last years. To achieve this we have reviewed the main academic literature on this subject, this approach allowing us to characterise the current banking supervision framework and also project future evolutions.

The reminder of the research is structured as follows: part two describes the implications and limits of the national supervision system versus a supervision at international level, part three proposes an efficient integrated system for the supervision and control of the European banking system, while part four contains the concluding remarks.

### **1. National Supervision vs. Supranational Supervision - Implications and the Limits**

A key element of creating an institutional framework for the European financial supervision is to identify the correct level of (de)centralization. Until now, national supervisory institutions have been mandated in the European Union with the task of supervising financial institutions. They coordinate their activities through the European supervisory committees. The role of these committees is to promote the convergence of the financial supervision standards and practices at EU level. While financial supervision is coordinated at European level, it is also specified in the national legislation of each EU member country. This issue leads to problems regarding the efficiency and effectiveness of the supervisory process.

Therefore, the European Commission and the European Council have outlined some suggestions to enhance the functionality of the European financial supervisory committees. The main set objectives are the strengthening of the political responsibility of these committees and of the internal decision-making process (through the introduction of qualified majority voting in these committees) as well as the revision of the supervisory authorities from national level mandates to ensure that these bodies are required to participate at the supervisory convergence process from the EU level [3].

In their paper, [8] they calculated the cost of a financial supervisory structures at the EU-15 level. Their results indicate that it could be achieved economies of scale due to the integration of the supervisory structures. Comparing a supervision structure formed of 15 national authorities with one

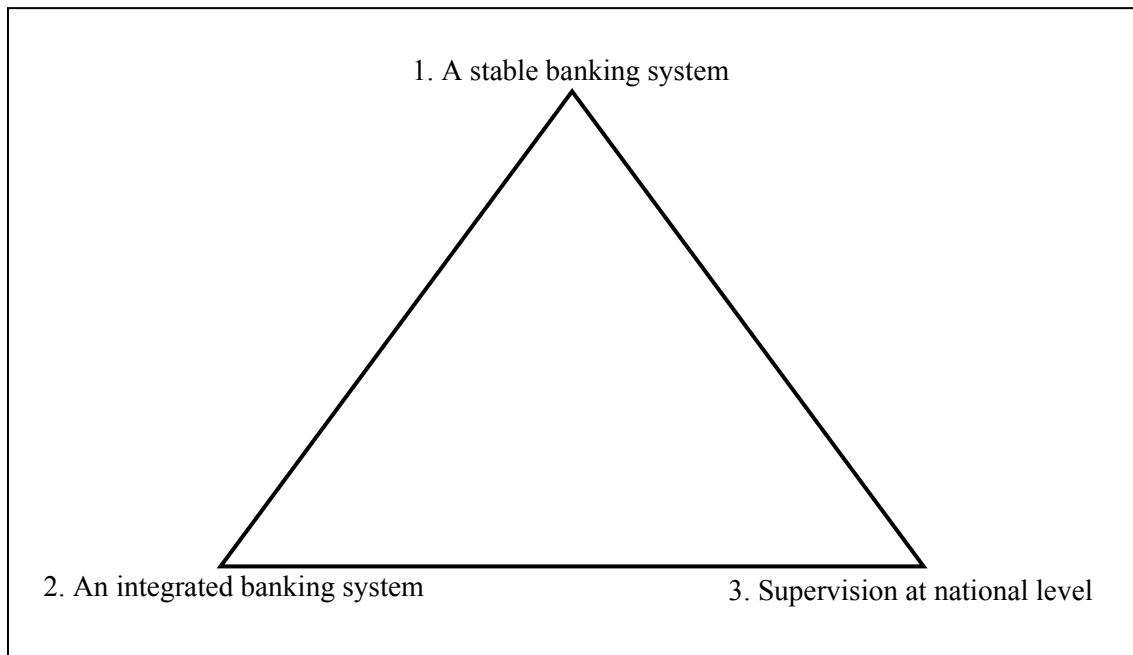
integrated at the European level,[8] emphasize the obtaining of a series of savings of 15% as a result of the financial supervision integration.

Another shortage of the national supervision system is represented by the possibility of the emergence of conflicts of interest between the supervisory authorities. While the European financial institutions are beginning to act increasingly at European level, the decisions regarding operations in different EU Member States being taken at central level by the coordinating entity of that financial group, the supervisory authorities which are fragmented at European level analyze only components of those multinational financial institutions. The supervisory authority from the country of origin of the financial group coordinates at a consolidated level the supervision effort in an attempt to reduce the possibilities of developing arbitrations due to the regulatory and supervision differences. The national supervisory authorities involved in this process make also some assessments of the risks associated with the operations developed by a financial group, agreeing on a common surveillance plan. However, there is no legal support for the existence of a series of mechanisms which could solve the potential conflicts of interest that may arise.

An obvious example of conflict of interest that may arise between national supervisory and regulatory bodies is represented by the way in which capitalization standards are imposed within a financial group. While the supervisory authorities would like that the subsidiaries of foreign banks operating in that particular market to be fully capitalized, the supervisory authorities from the financial group origin country may require only a minimum level of capitalization. Also, supervisory authorities may have different views on how the various shortcomings of the banking institutions present in several markets must be addressed. If there is a consensus on the issues that must be solved, the regulatory authorities in different EU countries can get very quickly to a joint action plan. But when there are (historical) disagreements, supervisors may want to take different national decision, which translates most of the time in a supervisory process far from the optimal one.

These problems of coordination bring into question the issue regarding if it would be better that the banking supervision to be conducted at national level or to be integrated at European level. The main argument behind the existence of an integrated banking supervision system at European level is that it would be extremely difficult to obtain simultaneously an integrated and stable financial system, in the context of a system of supervision and crisis management strongly segmented at national level, benefiting only of a few decentralized harmonization initiatives (see [9]). This fact was substantially highlighted in the case of the financial crisis triggered in 2007. The issue of banking supervision in the European Union resembles the trilema found in the case of monetary policy, where authorities face jointly three conflicting objectives: fixed exchange rates, capital mobility and monetary policies independence. Only two of these three objectives can be met simultaneously in a consistent manner, leaving the decision regarding which of these objectives must be sacrificed at the level of the regulatory authorities, from here coming the term of trilema.

A similar trilema was identified by [5]. Figure 5 illustrates the three incompatible objectives for banking supervision: 1) a stabile banking system, 2) an integrated banking system and 3) a banking supervision systems independent at national level. An argument against the development of an integrated banking supervision at European level may be the currently existing degree of banking integration. However we must take into account that certain financial markets, such as the corporate market, are almost fully integrated. The infrastructure related to banking services tends to be as well almost integrated, at least in the euro area, although progresses in this regard tend to occur more slowly. There are also a series of evidence that banking and insurance services tend to be provided increasingly within the European Union at the cross border level. The development of these pan-European financial institutions increases the risk that in the case of bankruptcy the effects will be perceived at European level. This leads implicitly to the undermining of national authorities capacity to effectively manage the potential risks and financial crises, in the context of an increasing number of financial entities (both banks and other financial institutions) that do not fall directly under their regulations.



**Figure 1. The supervision and stability system “trilema”**

*Source:* Own simulation based on the data provided by [5]

## **2. An Integrated Model for the Supervision and Control of the European Banking System**

In this context, there were a series of proposals regarding the development of a supervision organism for the financial structures that are operating in the European Union, this being underline also in the academic literature by the researches of [4] and [6]. These researches underline the existence of three possible actions, namely:

- the appointment of a leading supervisor for the regulation and the supervision of the pan-European financial groups. In practice this means that the regulatory authority from the state in which the pan-European financial group is located has all the responsibility for the supervision of its European activities, including branches and subsidiaries;
- the establishment of supervision entity at the European Union level for all the banks that are operating in it or at least for the banking groups that have cross-border operations in the Union (a two tire system);
- the establishment of a European System for Financial Supervisors, in which a central agency will work together with national control and supervision authorities from the member states. The role of the central agency will be to ensure the cooperation and the consistency of the measures adopted by the members of the Union, while the daily supervision and control activities will be left in the care of the consolidated supervision system.

According to the opinions stated on the European Financial Services Round Table ([1], [2]) the establishment of a main organisation (that normally will be in the state where the headquarters of the banking group are) that will handle the prudential supervision problems in the case of the banks with pan-European operations, will represent a major step toward a coherent and efficient supervision and control framework for the European banking system. The main supervisor should present a single contact point in each reporting scheme, will validate and authorise the internal operating models of the bank and will decide regarding the on the scene inspections that will be carried out. Also, the main supervisor should be responsible not only for the realisation of the consolidated control and supervision but also for each subsidiary of the banking group that is under his jurisdiction.

As part of this vision, the supervision authorities from the countries where the banking group is present should be also involved in this process, because they are the ones who know the best the characteristics of each of those banking markets. European Financial Services Round Table has

suggested the creation of supervision collages (one for each pan-European banking group) in which all the authorities involved in the supervision of the respective banking group should change information both on the overall operations and also on the more local and specific ones of that particular banking group. The main supervisor will coordinate this collage that will encompass at least all the supervision and control organisms from all the countries where that group is carrying out relevant activities. The main supervision authority will use in an efficient way the information that it will receive from the other authorities involved, having the possibility to delegate tasks and responsibilities where it will be necessary. It should also develop a mechanism for the mediation of the eventual dissensions that could arise in the case of disagreements between the main supervision authorities and the other national authorities involved in the process.

By comparison with the current system the scheme detailed above can increase the efficiency of the supervision and control activity of banks that are involved in pan-European activities through the elimination of the overlapping attributes of the national and international authorities. Despite all this, the main supervisor does not help to the increase of the financial stability of the European banking and financial system, because its national mandate does not take into account the implications of a possible bankruptcy of a banking group on the other countries in which it is present.

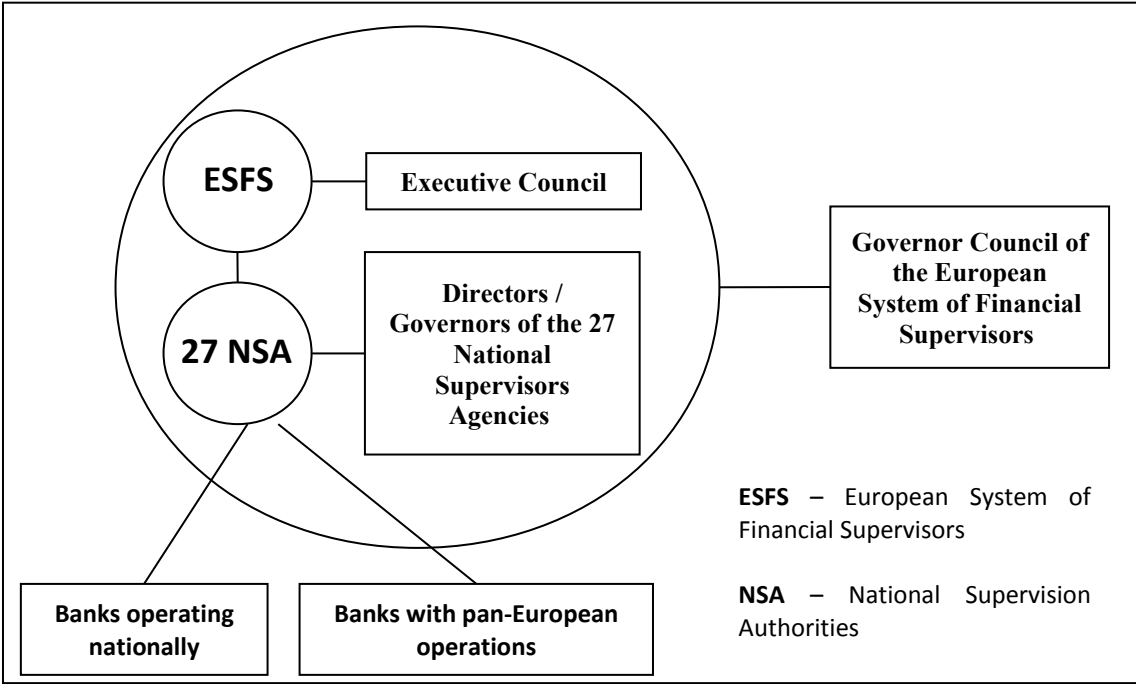
In another train of thoughts there are a series of opinions according to which as a result of the events that have taken place in the European banking system (i.e. the integration process) it should be developed a single authority at the European Union level that should supervise and control the activities of the banks from the Union, both at the subsidiary and branch level (e.g. [7]). There are also a series of arguments, especially as a result of the 2007 financial crisis, that support the centralisation of the information regarding the daily activity of the European banks in order to allow a more efficient evolution and understanding of the systemic risks to which the European banking system is exposed. Still, in our opinion, a fundamental shortage of this approach is represented by the relative high distance that exists between the central supervision authority and the banking institutions monitored – we are referring to the geographical dispersion but also to the particularities that exist in each banking market of the European Union. In this context, we can argue that the supervision and control of the banking activity can be more efficient if it will be carried out locally, because of the higher know-how that national authorities have regarding the characteristics of that particular banking market.

Another option will be to create a two-tier system, in which large banking groups with pan-European activities should be supervised by a European central authority while local banks will be supervised by the current local authorities that have this task. Still, we are considering that such an approach could lead to the creation of a discriminatory supervision environment between the pan-European banks and the local ones, as these two types of banks will be supervised and controlled differently as they compete for the same market. Moreover, the previous problem of proximity to the supervision and control authorities also exists in this case.

In their research, [10] and [6] propose the creation of a European System of the Financial Supervisors that should be centred around a European Financial Agency and the other different national regulatory and control authorities. Such a system could mimic the organisation of the Eurosystem. A key element of this approach is represented by the degree of (de)centralisation that the Agency would have. The supervision process represents firstly a micro activity that should be carried out as close as possible to the subject of this process. Despite all this, as we have presented previously, there could be a series of advantages that could arise from the centralisation of this process, especially in regard to the identification and quantification of the systemic risks that the European banking system could face. Also in this case the distance from the supervisor authority could be an advantage.

A decentralised structure of the European System of Financial Supervisors could take advantage of the already existing framework of the European Union and also of the expertise of the local regulatory and control authorities. In figure 2 is presented the functioning scheme of such a central structure that will have in its subordination 27 auxiliary supervision authorities, one for each member state. A key element of such an undertaking is represented by the fact that a system like this must work exclusively

under European mandate. In the proposed system, banks and small and medium insurance companies would be supervised and controlled by the 27 auxiliary authorities, especially because these institutions tend to be focused exclusively on the domestic market. In the case of the banks with pan-European operations, these will be supervised and controlled by the consolidated or main authority (normally the control and regulatory authority from the country where the headquarters of the banking group are located). This control institution should be the only contact institution for any reports in any supervision scheme (n.b. the need to report to the local authorities is removed), validating and authorising the internal organisation models of the banks, approving the capitalisation and liquidity schemes, certain cross-border functioning schemes and also the carrying out of onsite inspections. In regard to the onsite inspections, they can be delegated by the main authority to the local authorities, in order to be carried out in its name. The main supervision and control authority has the obligation to inform the national supervision and control authorities on the activities that it is undertaking allowing also access to the local authorities to any supervision schemes regarding the foreign banks that are operating within their jurisdiction (e.g. the existence of common data for the European System of Financial Supervisors). If one of the local control and supervision authorities considers that the main authority does not take into account its interests and cannot reach a compromise, it can call the System of European Financial Supervisors for mediation. If there are any violations committed against the existing prudential regulations, the European System of Financial Supervisors can overturn a decision taken by the main supervision and control authority and afterwards based on its European mandate can impose this decision.



**Figure 2. A model for the integrated supervision and control of the European banking system**  
*Source: Own simulation based on the data provided by [6]*

Regarding the management of the crisis at European level, this should be carried out on the same principals. While the national authorities for the supervision and control can handle the management of the crisis at national level, taking care of the affected banking institution/institutions (by gathering information and evaluating the existing situation), the European System of Financial Supervisors will insure an adequate solution for the respective problem from the European level. When the crisis will affect a series of big European financial and banking institutions, like in the case of the 2007 financial crisis, the implication of the European System of Financial Supervisor and of the European Central Bank will raise exponentially.

The key decisions regarding the supervision and control of the banks activity in the European Union (e.g. the analysis of the possible mergers and acquisitions that could take place in the European Union

in the banking sector, the decision regarding the management of the crisis) should be taken at central level by the Governor Council, which will be composed from the director of the European System of Financial Supervisors and the 27 directors/governors of the national supervision and control authorities of the banking system – this operating system is similar with the one of the Eurosystem for the adoption of the monetary policy decisions. This approach takes fully into account the opinion of the authorities from the countries where the banking group is active, the deponents rights from these countries being defended at the same time (in this way there are taken into account the externalities that the cross-border banking activity has). The supervision of the banks daily activity will be the responsibility of the authorities that have jurisdiction over it. The European System of Financial Supervisors has the responsibility to centralise all the received information and thus, has the ability to perform pan-European analysis regarding the activity of the different European banking groups.

Nevertheless, the European System of Financial Supervisors should be responsible with the correct and uniform application of the regulations regarding the control and supervision process of the banking activities (the insurance of a level playing field) having at the same time the attribution as we have mentioned earlier, to act as a mediator in the divergences that could appear between the supervision authority from the home country of the banking group and the other supervision authorities from the countries where the group has branches and subsidiaries. As a result of this role, the European System of Financial Supervisors could be mandate to issue instructions directly to the 27 local banking regulatory and control authorities regarding certain punctual measures that they must undertake. This mediation mechanism could be developed on the already existing structure of the European Banking Authority. A strong argument against such a functioning mechanism is that in a system with a central authority with 27 local authorities that supervise, control and regulate the European banking sector the decision making process is extremely laborious and heavy.

Regarding the establishment of a supervision and control system of the banking activity in the European Union there are two possibilities for action, relatively similar but with opposite results. A first approach is the revolutionary approach. The role of the General Directorate for Competition has been created from scratch as part of the competition legislation when the European Community of the Coal and Steel was created, because many of the member states did not have such a structure at national level. It is also interesting to mention that at the present time each of the member states of the European Union has a national authority for competition. This development has led to the creation ex-post of the European Network for Competition in 2004 which has introduced decentralisation elements in the process of supervising and controlling of the completion in the European Union.

The second approach is the evolution one. All the member states of the European Union had fully functional central banks when the System of European Central Banks was created, despite the fact that some of the member states had to change their national legislation in order to guarantee the independence of the central bank as it was mentioned in the Maastricht Treaty. The European System of Central Banks has been created in successive stages: The Committee of the Central Banks Governors from the European Union (stage 1) has been transformed in the European Monetary Institute (stage 2), which in turn was transformed in the European Central Bank and the Eurosystem (stage 3). In a similar way, the European System of Financial Supervisors could evolve naturally and integrate in the European Banking Authority. The latest changes that took place starting with the 1st of January 2011 and the transformation of the Committee of European Banking Supervisors in the European Banking Authority underlines the position of the European Commission for a development in successive stages of an integrated supervisory and control system integrated at European level.

A final element of our analysis is represented by the choosing of the organising structure of the banking supervision process at European level. The removal of the existent borders between the different sectors of the financial system implies the necessity for a supervision and control authority capable of carrying out an efficient activity in such a complex environment. Taking into account that there is a certain competition between the different models that can be employed in this case, the start of a European debate on this theme could lead to the development of a superior model for supervision and control to any one that exists today. Through the superiority of the model we are referring to the

capacity of this new scheme for supervision and control to efficiently fulfil the objectives of financial stability and prudential supervision. To this, we can add the fact that the development and the deepening of the integration process of the financial markets and implicitly of the banking market will lead to the necessity for the development of more efficient supervision and control mechanism.

Prudential supervisions role is to protect customers through the assurance of a adequate level of safety and robustness of the financial institutions, and especially of the banks. With the enhanced complexity of the organisation and the activities that are carried out by banks, the supervision and control authorities are trying to determine the banks to have a self control and to adopt a prudential attitude toward the risks that are willing to take. The new regulatory framework that will be introduced by Basel III will allow the European banks to optimise and better manage the capital and the risks, offering at the same time a better protection against systemic risks that could appear, like in the case of the 2007 financial crisis. The supervision of the way in which banks are caring out their activities is based on the supervision of the way in which they are treating their clients. The rules regarding the information that must be made public by banks allows banks costumers to take decisions in a more informed environment and thus be more aware if they want to enter in a relationship with that respective bank or not. To this we must add the necessity that the banks must offer their clients objective and high quality consultancy. The rules regarding banks operations that are enforced by local or European authorities ensure the existence of a correct and ordinate banking market.

The way in which banks supervision activity is organised has been changed both at European and national level. Thus, the place of the mono-sector classical approach (with supervision and regulatory entities specially dedicated to the banking, insurance and capital market sector) has been taken by the overall approach of the financial sector supervision through the adoption of a functional model (the existence of a control authority and of a supervision authority) or integrated model (the existence of a single supervision and regulatory authority). The functional model and the integrated model for the supervision and control of the financial sector allow a more efficient approach of this process, in the context of new extremely complex financial products, and of financial conglomerates that are covering banking operations, insurances and portfolio management that are offered at a pan-European level.

Nevertheless we must take into account that, as we have mentioned before, the financial systems are becoming more integrated, both at European and global level, which leads to an increase of the efficiency and the business opportunities but also to the more frequently manifestation of systemic risks in the case of the integrated markets. The process of developing a coherent framework for the supervision and control of the banking activities in the European Union has been accelerated with the start of the financial crisis in 2007, the recession and the sovereign debt crisis. Thus the supervision and control activity has been switched form an individual collaboration at European level to the building of an entire framework for the execution of this process in an integrated meaner at European level. Even though the first steps are very promising the road is long and the project is far from being perfect and completed.

### **Conclusion**

In a broad approach the European Union is faced with the challenge of straightening its capability to produce high quality regulations for a banking system increasingly more complex and integrated. This is largely related the problem posed by the need of allocating vast resources for such a project. In the two decades before the 2007 financial crisis, the European Union has based its undertaking on the momentum created by the financial convergence process that has been registered globally, and which has been determined largely by the initiatives of the private sector as a result of the deregulation process of the financial markets, this contributing as a extremely powerful extern factor in the process of financial harmonisation at the European Union level.

This context has been fundamentally changed by the events started with the 2007 global financial crisis. The deepening of the reregulation process of the financial markets in a multi-polar financial environment, impacted by the development of new powerful financial centres in the emerging economies, has made the convergence of the financial regulation at the global level a process hard to

complete. In this complex economic and financial environment, the European Union has been faced with a great effort of developing and imposing uniform regulations for the banking sector in order to prevent its collapse and avoid any new complications.

The creation of the new Financial Supervision Authorities can help the development of a distinctive philosophy of the supervision and regulatory process for the banking sector, specific for the European Union, that will represent more than a compromise between the member states. But, in order to achieve this and taking into account the previous experiences, we can anticipate a long and slow process, but which, if done right, could provide the incentive for a long term sustainable economic growth in the European Union.

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