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Supervision of the Integrated European Banking Market: Time to Rethink the Institutional Framework?

a diploma thesis

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Affirmation

Author declares that the thesis was elaborated on his own with the use of listed sources only.

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Abstract

The aim of the thesis is to analyse the Europe-wide banking supervision. The thesis points out the existing problems and shortcomings of the current framework, analyses mutually competitive proposals for change and possibility of their implementation. It incorporates the appraisal of currently proposed legislative changes prepared by the European Commission and their impact in this context.

Despite a very narrow focus of the thesis, it is characterized by a holistic approach. The topic of banking supervision at the level of the European Union is considered in a much broader institutional context, in the context of the integration of the banking sector during the past 30 years, and the latest financial crisis, as well. The thesis is evolutionary. It points out that there is no institutional form of efficient banking supervision. The process of institutional change, leading to the achievement of efficient supervision of the banking sector, is perceived rather as a long-run, in-depth process. It follows institutional changes in a much broader context than that of the banking supervision itself.

Abstrakt

Cieľom tejto práce je analyzovať dohľad nad bankami v celoeurópskom merítku. Práca poukazuje na existujúce problémy a nedostatky dnešného usporiadania, analyzuje vzájomne si konkurujúce návrhy zmien a posudzuje možnosť ich implementácie. Jej súčasťou je posúdiť v tomto kontexte súčasné legislatívne zmeny, pripravované Európskou komisiou a ich dopady.

Napriek tomu, že práca má veľmi úzke zameranie, je pre ňu vlastný holistický prístup. Otázky bankového dohľadu na úrovni Európskej únie sú vnímané v širšom inštitucionálnom kontexte, v kontexte integrácie bankovníctva za posledných 30 rokov, ako aj poslednej finančnej krízy. Práca je evolucionistická, poukazuje na neexistenciu instantnej formy efektívneho bankového dohľadu. Proces inštitucionálnej premeny vedúcej k dosiahnutiu efektívneho dohľadu nad bankovým sektorom je vnímaný skôr ako dlhodobý a hlboký proces a sleduje inštitucionálne zmeny v ďaleko širšom kontexte ako len samotného usporiadania bankového dohľadu.

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List of abbreviations

BIS	Bank for International Settlements
CEBS	Committee of European Banking Supervisors
CEE	Central and Eastern European
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CNB	Czech National Bank
COM	Commission of European Communities
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EEC	European Economic Community
EFA	European Financial Agency
EIA	European Insurance Authority
ELA	Emergency Liquidity Assistance
EONIA	Euro Overnight Index Average
ESA	European Securities Authority
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESRC	European Systemic Risk Council
FDIC	Federal Deposit Insurance Corporation
FED	Federal Reserve System
FSAP	Financial Services Action Plan
NMS	New Member States
PCA	Prompt Corrective Action
SEA	Single European Act
SEC	Securities and Exchange Commission
SEIR	Structured Early Intervention and Resolution
SEPA	Single European Payment Area
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer System
USD	United States dollar
VAT	Value added tax

Preface

During the financial market's turmoil in 2008-2009, many economists and politicians came up with the idea of insufficient supervision of financial institutions that created, or contributed to the crisis. The public asked for more or stricter regulation and supervision. The economists were accused of being useless because they are unable to forecast or prevent a crisis. However, many economists warned that supervision was not working properly, many warned that there was a bubble on the market, that the monetary policy was wrong, etc. The topic itself became very popular and many researchers targeted their interest at it. The aspiration of this thesis is not to explain the reasons or find who is guilty of a crisis.

The objective of this thesis is to describe the main features of current banking in Europe, as it has evolved over time, and to analyse how current regulatory and supervisory framework fits to the current state of the banking sector in the European Union. Then it is focused on finding the principles upon which supervision in the EU should be built and how they should be implemented. They are be compared with the actual development that took place after the crisis.

The thesis is not devoted to the crisis *per se*. The crisis will rather be a part of a puzzle. It is based on a wide range of pre crisis and post crisis literature. Literature that provided the foundation for the thesis is devoted to the topics of the European integration, banking regulation and supervision, the systemic risk and cross border contagion, the lender of the last resort, and deposit insurance. Of course, the most of the literature is up to date, since the time dimension of the problem is important. The evolutionary approach is observable along the thesis. The author is convinced that there is no unique supervisory model which will be optimal for eternity and will avoid all crises. It does not make sense to build a new supervisory system to avoid crises similar to the latest one. In my perception, each crisis is somehow different, so the next crisis, which will occur, will be different to the last one. Therefore the principles should be more general and super-temporal.

Historical time is important. I would like to put stress on changes that occurred prior to the 2008-2009 crisis. Borders among the banking, insurance and securities markets vanished over the last decades. Therefore it is worth to analyse interconnections between these segments. Large financial conglomerates, where the links are direct,

already exist. But as we have observed during the crisis, many other banks were involved in the securities market indirectly, via sub-balance sheet items. The securities market turned out to be the source of the banks´ problems. In many countries supervisors are integrated, while in many other countries they are not and have to cooperate. A natural question that one might pose is which model is preferable.

There has always been a discussion about optimal supervisory model at the national level. Discussion has been whether it is better to have a single supervisor to supervise the banking, insurance and financial markets, or to have a separate supervisor for each field. Should the supervisor be a part of the central bank or should it be an independent institution?

The securities markets were important with regard to the latest crisis. An unregulated and unsupervised market participant, such as hedge funds, which raised huge amounts of money, become systematically important and was able to cause a financial crisis largely affecting the banking sector. For those, seeing the systemic risk and maintaining the financial stability as the most important or the only reason for banking regulation and supervision, extension of the regulation and supervision to cover these entities is an important outcome of the financial crisis.

Mergers and acquisitions resulted in the creation of large financial institutions, which are perceived to be too big to fail. Treatment of these subjects is different compared to other entities, since the government bailout is expected. As soon as a problem occurs, not only shareholders and a big number of market participants with exposure *vis-à-vis* this institution are in troubles, but also the governments of the countries involved, who can not afford a collapse of such an institution. Restriction to the creation of such institutions was contained in some research papers devoted to the topic.

In the EU, where supervision is fragmented, we have national supervisors on one hand and large, complex financial conglomerates on the other hand. Large multinational banks themselves would like to have counterparts of the same size. Dealing with a number of national supervisors in each of the EU countries imposes an additional burden on them.

All these topics have something to do with the European banking supervision. However, it is not possible to cover all the topics in detail within the scope of a diploma thesis. Therefore, supervision at the EU level and all issues will be in the centre of the thesis. All the above-mentioned topics are only mentioned with minor interest, in

chapters where needed. The stress is put on issues affecting the architecture of the institutional framework at the EU level. All topics concerning this issue are analysed in detail on the expense of above mentioned topics. The structure of the thesis is based on the evolutionary feature. First, grounds upon which the EU market is being built are analysed. The reached level of integration is discussed then. The analysis of the regulatory and supervisory framework in place follows. Based on the detection of shortcomings and potential risks of the current framework, principles for the enhancement are formulated. Only then various academic and politic proposals can be evaluated. However, it does not deal with the principles for the supervision for the particular states, but for the EU as a whole, since the thesis is devoted to the supervision at the EU level. A part of the thesis is dedicated to the real post crisis development and measures that where taken.

1. Integration of the European banking

"…it might be time to put the Horse in front of the Cart, that is, transferring bailing-out and supervisory powers to a European authority before the process of banking integration is fully completed."

Jean Dermine (2005)

During the past decades, Europe witnessed an unprecedented integration of sovereign countries. This process created conditions for sustainable growth of mutual trade, economic growth, and created assumptions for further common projects such as creation of European Monetary Union. Since this process was not only economic but also political issue, some questions were postponed or blocked for many years. Banking was always perceived to be a politically sensitive topic and the integration of banking market was a very slow process. The First Banking Coordination Directive 77/780/EEC was adopted already in 1977, but the most important measures were not adopted prior to 1980´s. The Single European Act (SEA) was signed in 1986 and effective since July 1, 1987. Its objective was to create Common Market by the end of 1992. Basic principles introduced by SEA in banking were home country control, single banking licence and mutual recognition.

The creation of the Common Market instead of the existence of fragmented national markets should allow market subjects to benefit from the economies of scale and motivate them to expand beyond the former national borders. Customers in turn benefit from the existence of large, diverse, competitive and effective market. However, along with the potential benefits, problems such as need for harmonisation of regulatory requirements and cooperation in supervision occurred. Although this thesis deals with the latter ones, the first chapter of the thesis will be more descriptive and should provide the first insight into the problems of the European banking integration.

In the following parts I will briefly describe the integration of the European banking. Section 1.1 describes development of the regulatory framework during last decades and currently valid regulation. Section 1.2 describes reached level of integration and contains contemporary empirical evidence and possible impediments to the deepening of the integration. Section 1.3 is devoted to the market structures in the EU and its member states. The concentration and foreign banks penetration will be

investigated in this chapter. Issues of systemic risk and of cross border contagion and empirical evidence on cross border contagion are embodied in Section 1.4.

1.1. Regulatory Framework

"Any change, even a change for the better, is always accompanied by drawbacks and discomforts."

Arnold Bennett

Banking sector is one of the most regulated sectors. The reasons for regulation can be summed in three categories – information asymmetry, moral hazard and systemic risk. Informational asymmetry exists among depositors, banks´ shareholders and management, since (small) depositors cannot obtain all relevant information they need and if deposit insurance exists, they loose incentives to monitor banks as well. Recalling the case of Northern Rock bank, it seems that sometimes it is a difficult task for supervisors as well. Moral hazard stems from the interest of shareholders to invest into riskier projects to generate higher profits. They will take all the profit, while sharing the risk with depositors. Another reason for a regulation is systemic risk. Due to close links among banks, failure of one bank can cause problems to other banks with possible impact on the whole economy. The aim of the EU to create the Common Market means that systemic risk can be spread widely and there is need for regulation on the European level as well.

The Financial Services Action Plan (FSAP) was the most important measure with respect to the banking integration so far. It consisted of 42 measures aimed at creation of fully integrated wholesale banking and capital markets and at developing open and secure markets for retail financial services (Cabral et al., 2002). FSAP was launched in 1999 and was largely completed by its deadline in 2004.[1] In terms of European legislation procedure fulfilment of 41 out of 42 measures in time is a great success, enabled by the Lamfalussy process. Success of the FSAP is documented by the implementation of legislative proposals blocked for 30 years such as, for example, "The Council Regulation on the Statute for a European company" (Regulation 2001/2157).

[1] See European Commission (2007) for details.

This measure allowed banks operating in more than one EU member state to establish a single company under the Community Law and to operate on the basis of one set of rules throughout the EU (Cabral et al., 2002). Moreover, during the implementation of the FSAP accounting scandals in the US and later in Europe emerged (Enron, Ahold and Parmalat scandals), which provoked additional measures similar to the Sarbanes Oxley Act to be introduced within the framework of the FSAP.

Adopted directives had to be transposed into national laws. Transposition was much slower, European Commission (2007) states that only 12 out of 21 directives were fully transposed into national laws of all 25 member states by December 1, 2006. Most problematic parts for transposition were the Takeover Bids Directive not implemented in 9 member states, Transparency Directive and Directive on Markets in Financial Instruments not implemented at all on national level by January 15, 2007 (European Commission, 2007). Takeover Bids Directive is an especially important part with respect to the expected consolidation by means of cross-border acquisitions, but politically difficult to be implemented at the same time. Another problem of the transposition of the directives is that national legislators are usually free to interpret them and during the process of negotiation some countries obtain exceptions in order to agree with the directive. Therefore the legal framework is quite heterogeneous despite the effort to harmonize rules on the EU level. First of all, criteria for credit institutions[2] vary slightly in the EU member stats (De Larosière Report, 2009).

Recently, treating pursuit of banking business is treated by following directions:

- Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)
- Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast)
- Directive 2000/46/EC of the European Parliament and of the Council of 18.9.2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions and
- Directive 2002/87/EC of the European Parliament and of the Council of 16.12.2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

[2] In the EU legislature, term credit institution is used instead of bank.

Basically, rules in the EU are based on the minimal harmonization principle, i.e. allowing for stricter rules and in accordance with Basel and later Basel II principles. Majority of countries elaborating Basel and Basel II standards are the EU member states, therefore level of harmonization of regulatory and supervisory standards had been high even before the harmonization took place within the EU framework.

Regarding the deposit guarantee, the system has been founded on the top-up principle since the adoption of the Directive 94/19/EC.[3] Branches can participate on the host country deposit insurance, if the coverage is higher than that of the home country. In the case of subsidiary, host country scheme is to be used.

The Green paper on financial services policy (2005-2010) reflects contemporary needs, especially with respect to the slow integration of retail banking. Creation of the Single European Payment Area (SEPA) and operation under the regime of the European laws are the most important tasks to be done. De Larosière Report (2009) presents main problems of the regulatory framework that appeared during the crisis. The report refers to the need to harmonize the rules within the EU or to set minimal requirements, thus to allow countries to opt for stricter requirements. Report does not distinguish when these principles should be applied. However, when a "race to the top" is expected, then allowing for stricter criteria seems legitimate. Not all inconsistencies are more or less anecdotic as a different interpretation what is credit institution and what is not.

There are different definitions of a core capital in the EU countries. Core capital or Tier 1 capital is composed of the paid-up share capital[4] and disclosed reserves.[5] Core capital is the most elementary regulatory requirement for banks. According to Stiglitz (1993), this type of requirements is of the highest importance - if set properly, all other issues are less important. In spite of the fact that supervisors use different calculations for core capital what leads to formal obeying of the same rules, but in reality to very different levels of core capital.[6]

[3]Most recently, amended by Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance)

[4] Issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock) (BIS, 1998).

[5] Terminology is not unified as well, some authors use Core capital and Tier 1 capital as synonyms, while other authors use Core capital as equity, i.e. part of Tier 1 capital. For detailed rules of calculation of Tier 1capital, see BIS (1998) and BIS (2005).

[6] Padoa-Schioppa (2008) criticized totally different requirements in different countries despite foundations in same directives and Basel II accord as well.

Table 1 reveals the problem of different measures of national core capital and shows the unclear relation to the Basel Tier 1 ratio and comparison to the US and Switzerland. Heterogeneous framework impedes both credit institutions in their cross-border activities while increasing compliance costs, and supervisors in cooperation and information sharing.

Table 1: Core bank soundness ratios in selected EU countries, Switzerland and US, 2007

	Top 5 bank assets as % of GNP	Loans to deposits	Core capital ratio	Basel tier 1 ratio
Belgium	463	104	4	
France	293	101	3.5	7.4
Germany	165	94	2.6	8
Ireland	404	197	3.6	
Italy	131	161	7.4	6.6
Netherlands	521	125	3.8	10
Spain	184	250	7.2	7.9
UK	313	125	3.9	7.6
EU 27	**237**	**133**	**4.3**	
Switzerland	756	69	3.2	9.8
US	**44**	**91**	**7.6**	8

Source: Lannoo (2008)

1.2. Reached level of integration

"Goal properly set is halfway reached."

Abraham Lincoln

Usually, integration and competition are perceived to be two sides of the same coin and are exploited at once. There are few ways how to measure reached level of integration. Traditional approach is based on the law of one price. Under this approach market is perceived to be integrated if there is the same price for one product throughout the relevant market, the European market in this case. To measure a price for banking services is a difficult task indeed. One can measure whether all clients pay the same fees for the same services. Concerning credit prices in terms of interest rates, charging

different rates to different clients is the basis of the banking business. Dermine (2005) provides us with plenty of arguments, why this approach is not suitable for banking products.

Another way how to evaluate the degree of integration is using quantity-based indicators such as, for example, cross-border borrowing and investment, cross-border mergers and acquisitions, etc. Most recently, econometric techniques such as cluster method, stochastic frontier model and meta-frontiers have been employed.

Prior to providing an evidence of the degree of integration in the European Union, it is worth mentioning that not only the removal of legal and regulatory obstacles by the adoption of common legal and regulatory framework matters. Lowering transaction costs by means of creation or joining the Euro area is another important factor of integration. Therefore one might expect different level of integration among Euro-area countries and other EU member states.

Moreover, there is different degree of integration in the various segments of banking as well. Following the law of one price and the quantity based approaches of Cabral, Dierick and Vesala (2002)[7] and the European Commission (2004 and 2009), differences among segments are notable and have not improved much over time. All three papers conclude that the wholesale market is fully integrated, but secured (repo) segment is less integrated than the unsecured one.[8] According to the findings of the European Commission (2009), integration of the secured segment did much better during the financial turmoil than the unsecured segment, what they document on the widening of the dispersion in EONIA. These findings are important for the Euro area only. According to Cabral, Dierick and Vesala (2002), cross-border activity involving non-euro counterparties decreased in favour of the Euro area business. In the field of market-related banking activities, one can expect much higher integration in the Euro area due to the lower risk within the single currency conditions.

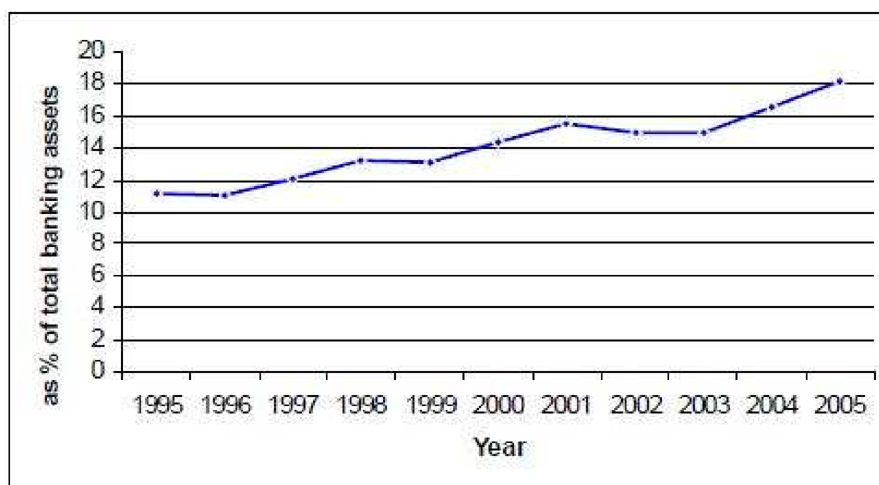
The process of Integration is slow in the retail segment despite decreasing differences in banks´ margins. However, as Chart 1 suggests, the trend is clear. Cabral, Dierick and Vesala (2002) explain the convergence as a result of monetary policy and not as a result of changes on the micro level. European Commission (2009) explains the different degree of integration in a wholesale and retail banking partly by the

[7] Cabral, Dierick and Vesala (2002) explore banking integration in the Euro area only.
[8] Share of other than domestic Euro area counterparties is higher in repo segment, but small difference is, according to European Commission (2009a), a sign of lower than achievable integration.

introduction of the payment systems TARGET, later TARGET2 and EURO1 for wholesale, while only STEP2 system is operating on the cross-border basis in retail payment. They conclude that SEPA[9] will bring more competition and integration in retail sector in the future and despite existing differences the process of integration is progressing in this sector as well. Chart 2 suggests that also within the retail segment there are differences in the integration measured as standard deviation varies significantly. Moreover, differences are not observable among the countries only, but also within the countries.[10] Chart 3 suggests that the above mentioned findings are less meaningful for the non Euro area countries, but the difference is not large.

The fragmentation of retail market is not as important measure of integration as one might think. Padoa-Schioppa (2004a) points out that in the US restrictions for interstate banking were lifted more or less at the same time as in the EU with similar results as in the EU. Therefore, according to Padoa-Schioppa, success reached in the level of wholesale integration is much more important.

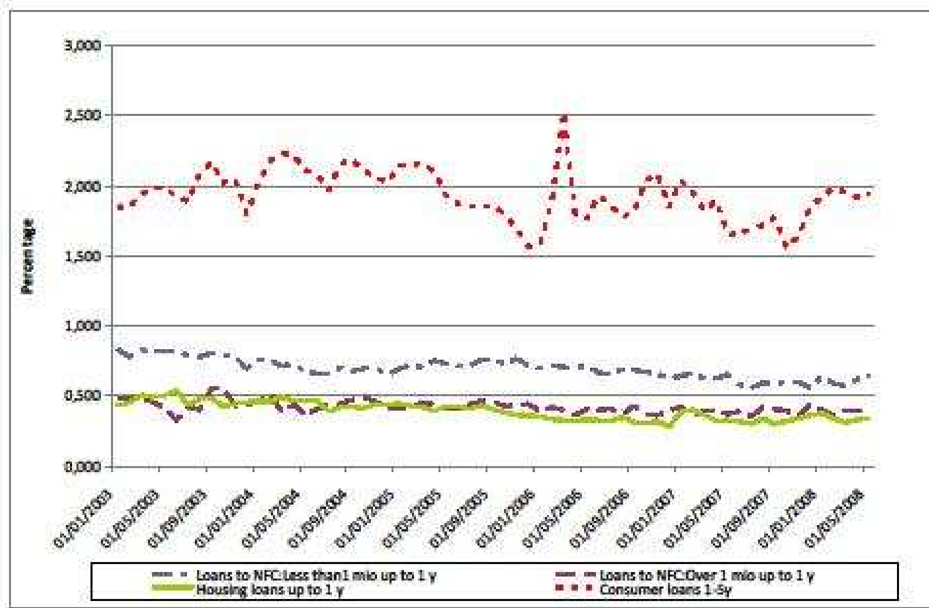
Chart 1: Cross-border penetration in European Banking



Source: Schoenmaker and Oosterloo (2008)

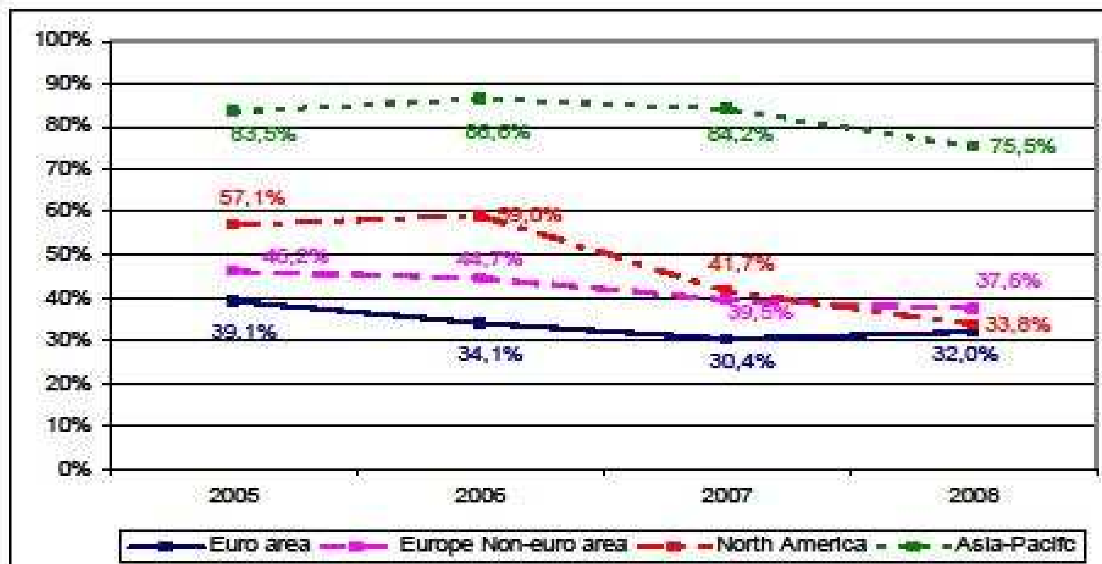
[9] Under SEPA all Euro payments will be domestic payments.
[10] Cabral, Diercik and Vesala (2002) point it out on the examples of Germany, where differences in interest rates are significant among Federal Laender, and Italy, where differences in interest rates are significant among Northern and Southern regions.

Chart 2 : Standard deviation of Euro area retail interest rates (in %)



Source: European Commission (2009)

Chart 3 : Regional price discrepancy for local active users of banking services



Source: Capgemini (2008)

Sørensen and Gutiérrez (2006) applied cluster analysis techniques[11] to examine financial integration, mainly focused on banking sector, within the Euro area. They addressed two important questions: degree of cross-country homogeneity and the evolution over time. Their survey shows that there are still differences among Euro area countries even though clusters containing countries with very similar characteristics can be created. The study refers to some progress in integration, most likely generated by the Euro currency introduction.

Bos and Schmiedel (2006) applied stochastic frontier model and meta-frontiers[12] on the sample of 5,000 European commercial banks over the period of 1993 to 2004. In fact, their approach was to evaluate efficiency under country specific conditions and consequently to evaluate competition and level of integration. They found evidence of the existence of single and integrated European banking market based on the cost and profit meta-frontiers.

To sum it up, the process of integration of banking industry within the EU is slower than one might have expected with respect to the integration of other segments of financial markets. Further, integration of various segments of banking industry is heterogeneous, with retail banking still being mainly a local business. Wholesale banking is fully integrated. Despite the above mentioned shortcomings, the reached level of integration is not negligible at least.

1.3. Market structure

"The rate of change is not going to slow down anytime soon."

John P. Kotter

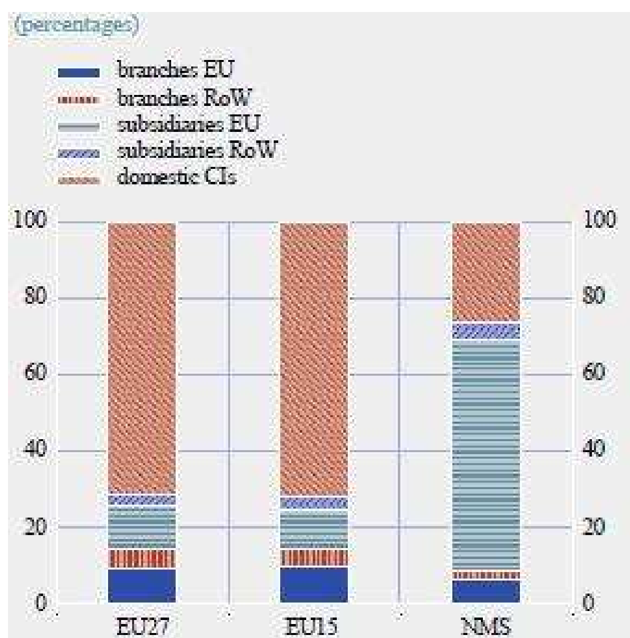
Despite the fact that the thesis is devoted to the supervision of the European market, this part will be devoted to the differences among national markets. Share of foreign banks operating on domestic market, volume of cross-border mergers and acquisitions are also signs of market's integration. Following the differences among

[11] All variations of cluster method are based on the dividing of countries into groups of similar countries – clusters, see Sørensen and Gutiérrez (2006) for details.

[12] Meta-frontier method is based on the estimation of meta-frontier, which is viewed as an "envelope" cost and profit function that encompasses banks operating under different circumstances. For more details see Bos and Schmiedel (2006).

countries in reached level of penetration of foreign banks can easily draw different stances of supervisors to the same supervisory or regulatory issues, as will be discussed later on. It will therefore help to understand different attitudes of representatives of the EU countries.

Chart 4 : Share of foreign bank branches and subsidiaries in 2007



Source: ECB (2008)

Share of foreign banks is less than 30% in all old member states (EU15) with the exception of Luxemburg, Great Britain and Ireland. By contrast, foreign banks have been able to gain a dominant position in markets of all new member states (NMS12).[13] The situation is depicted in Chart 4. In some NMS12 countries, such as the Czech Republic or Estonia, the foreign banks´ market share is almost 100%. This huge difference is the result of banks´ privatization in post-socialist countries on one hand and protectionism of some old member states on the other hand. Privatization of banks by means of direct sale to foreign banks was chosen as a solution in most post-socialist countries due to weak performance of banks in state hands during the transition. Newly established domestic private banks never achieved the size of the most important market players in these countries with the exception of Estonian Hansabank, later sold abroad to Swedbank as well, and Latvian Parex, which went bankrupt. During the early years

[13] Based on Derimne (2005)

of transition when governments were reluctant to privatization of state banks into foreign hands due to the fear of credit crunch, the penetration of foreign banks in form of from-scratch-investment was observable as well. These banks were usually active in providing services to foreign and top domestic corporate clients.

However, as Chart 1 suggests, there is a clear trend of raising the overall cross-border activities, market share of foreign banks is rising over time. Market share of foreign banks is less important if banks operate as subsidiaries and are controlled by host country. In this case, it can be perceived as equity participation only. If they switch to branches, supervisors of host countries, the only ones who care about financial stability of the country, will lose means how to control this objective, as will be discussed later on.

European Commission (2004, 2009) refers to much slower consolidation on the European level compared to the national levels. Bos and Schmiedel (2006) point out that banks are usually very efficient at home but not equally successful abroad, hence cross-border mergers are limited. Focarelli and Pozzolo (2001) conclude that smaller volumes and also values of cross-border mergers and acquisitions are caused by informational asymmetry and non-regulatory barriers, such as public interventions to deter the entry of foreign banks.[14]

Higher pace of consolidation in national markets resulted in rising concentration on domestic markets. Of course, there are differences among countries; there is higher concentration in smaller markets. Consolidation by means of mergers and acquisitions supported by the deregulation of financial services in the EU resulted in the rising level of concentration in most European countries since 1997 (Casu and Girardone, 2006). Current development (2003-2007) is available in Annex 1. Mergers and acquisitions cause another phenomenon - creation of banks which are perceived to be too big to fail. Mayes (2006) discussed this problem and stated that supervisors should be careful when such financial institution is to be created.

In the past, there were debates only on concentration, competition and efficiency. Relationship between competition and soundness was perceived to be clearly negative. However, recent papers as *inter alia* Schaeck and Čihák (2008) show that this

[14] See Dermine (2005) for examples such as the competition of ABN-AMRO and Banca Popolare Italiana to acquire Banca Antonveneta, where ABN-AMRO accused the Bank of Italy of unfair treatment. Goldberg et al. (2005) mentioned the discriminatory practices in Portugal, when Banco Santander was willing to acquire Portuguese bank and again discriminatory practices in Italy, when BBVA tried to acquire Banco Nazionale del Lavoro.

relationship should not be perceived as clear, but doubtful at least. On the extensive sample of European and US banks they provided empirical evidence that efficiency caused by higher competition plays an important role in achieving soundness of the banking system.

From the policymakers´ perspective, it is crucial to decide about the desired level of concentration. Higher concentration might hinder competition and efficiency; on the other hand economies of scale might eliminate those effects.[15] Further mergers or acquisitions in domestic markets can be hindered by supervisory and antitrust bodies willing to support more competition or to prevent creation of too-big-to-fail credit institutions. Unwillingness to give up supervisory powers can hinder further cross-border mergers and acquisitions, since the home country control principle is in force. On the other hand, there is a motivation to develop economies of scale by creation of large multinational banks.

1.4. Systemic risk and cross-border contagion

"There's no such thing as a free lunch."
Milton Friedman

Systemic risk is a risk that some affair will cause problems to the whole financial system.[16] Problems of a large (enough) bank may be the triggering event, especially in the case of high interbank links to other banks. Systemic risk is one of the reasons for banking supervision.[17] Maintaining financial stability was mainly a national goal until recently. Development in recent decades, especially in the EU, has added a new dimension to issues of systemic risk and financial stability. However, it is dubious whether the institutional arrangement reflects needs of today's world or needs of the past.

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[15] Development in new member states in 1990´s shows that few strong banks can create more competitive market than tens of undercapitalised weak banks. Relationship between concentration, competition and efficiency can be found in *inter alia* Casu and Girardone (2006), Corvorsier and Gropp (2001).

[16] There is no generally accepted definition of systemic risk, for comparison of various definitions see Carmassi (2009) and Schinassi (2006).

[17] On contrary Carmassi (2009) argued that systemic risk, itself, is not necessarily a reason for supervision. He points out that hedge funds are of systemic importance as well, as could be documented on FED's inclusion of hedge funds in the Term Auction Liquidity Facility. Hedge funds are not subject to supervision despite systemic importance.

Banks in each market are usually highly interconnected via the interbank market, an important channel for managing liquidity. Especially during the crisis, when the interbank market did not function properly due to lack of trust, it turned out how important the interbank market was. Interbank market is not a domestic affair. Nowadays, when multinational banks operate in tens of countries, possible systemic risk has turned into potential cross-border contagion. Cross-border contagion is the international dimension of the systemic risk problem. In other words, cross-border contagion refers to the spread of problems from one or more banks to other banks abroad. It is a typical trade off case, the higher the degree of integration of banking systems, the greater the vulnerability to external shocks.

In the previous subchapter, linkages among banks and was shown that, especially in post-socialist countries, banks were dependent on their western European parent banks. Different level of penetration of foreign banks on domestic markets of the EU countries may signal different possible scales of cross-border contagion. Of course, not only equity participation matters, there are different channels for cross-border contagion. This issue is particularly important for the EU, because, as was already mentioned in the previous subchapter, wholesale banking is fully integrated in the EU. The problem of contagion was observable during the financial crisis as well, when banks in the EU imported problems from the US. Many European banks were hit by the crisis heavily despite much lower interdependency of the European and American financial system than the interdependency within the financial system of the EU. What is more, as Freixas, Parigi and Rochet (2000) suggest, the contagion may be caused by unforeseen liquidity shocks arising from the informational asymmetry combined with bank runs on solvent banks.[18] Therefore, contagion may occur without a fundamental reason.

Empirical evidence on cross-border contagion in the world does not reject this possibility. Hitherto, Gropp, Lo Duca and Vesala (2006) are probably the only ones to analyse the existence of the contagion in the EU. They analysed contagion on the sample of European[19] banks in the period of 1994 to 2003 using a multinomial logit model and provided us with survey of older empirical evidence. They conclude that significant pan-European cross-border contagion exists. According to them, cross border contagion may be strengthened by the introduction of the Euro currency. Patterns

[18] The Northern Rock case
[19] Banks from France, Germany, Italy, The Netherlands, Spain and the United Kingdom

of contagion were supported by the robustness checks to changes in specification, method of estimation, selection of banks etc. Moreover, in their model contagion was measured as a distance to default during the calm period without any turmoil; hence they conclude that mentioned results should be taken into account as a lower bound of a real contagion. The last point of their paper is that contagion is not distributed evenly. There is very low contagion among small banks compared to the contagion among large multinational banks, what is not surprising. De Larosiére Report (2009) accepts this view of contagion in the EU.

Supervisory structure able to cope with systemic risk of one country is not adequate in today's world of integrated financial markets. If supervisor maintains financial stability, cross border issues must be taken into account. However, each national supervisor is responsible for the financial stability of the one particular country only; therefore incentives of the supervisors might differ. Supervision based on a national mandate with differing objectives of national supervisors will be suboptimal indeed. This problem has been already observed but, as will be discussed later on, not solved sufficiently.

2. European Banking Supervision

"All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident."

Arthur Schopenhauer

In the previous chapter we have concluded that there is a rising level of integration in financial markets, especially in the wholesale market, which is fully integrated. Retail banking is still a local business but foreign presence thereby integration is in progress. We have shown that not all countries are the same. Banks in NMS12 are heavily dependent on foreign bank owners. If the share of foreign banks on domestic market is perceived as a measure of integration, these markets are the most integrated in the EU. In the last subchapter we have shown that supervisors had to move from safeguarding financial stability against systemic risk to safeguarding against both systemic risk and cross-border contagion.

In this chapter we will discuss the current supervisory arrangement in the EU and dealing of the EU with the above mentioned novel features of today's world. First subchapter describes basic principles of current supervision. Second subchapter is devoted to dealing with different corporate structures under current supervisory framework. Third subchapter will discuss problems of the current supervisory structure, especially those that occurred during the financial crisis. Fourth subchapter is devoted to the lender of last resort, deposit insurance and public spending related issues. Fifth subchapter concludes.

2.1. Current Supervisory Structure

"The only man I know who behaves sensibly is my tailor; he takes my measurements anew each time he sees me. The rest go on with their old measurements and expect me to fit them."

George Bernard Shaw

The current supervisory structure has been described as a home-host supervision since the adoption of the Second Banking Directive (Directive 89/646/EEC), which incorporated the Single Market issues for the first time. Supervision was therefore not integrated along with the integration of the banking industry. It means that regulatory framework is harmonized enough that credit institutions are allowed to operate in other EU member states without any additional permission and they are supervised by a home country supervisory authority. This is true, if banks open a branch in other EU country, not in the case of a subsidiary. Subsidiary is supervised by host country, i.e. country where it operates.

In the case of branches, the host state may intervene on behalf of public interest. It may intervene in matters of liquidity, monetary policy and advertising. Moreover, in emergency situations, the host country supervisor may, subject to *ex-post* Commission control, take any precautionary measures necessary to protect depositors, investors and others to whom services are provided (Walkner and Raes, 2005).

If regulatory and supervisory standards set by supervisors differ, then one can conclude that two banks operating on the same market face different requirements. If so, then playing field for market participants is not level. There is need for harmonization of the rules and requirements, in order not to violate the basic principles of market economy.

Cooperation and coordination among supervisors is crucial under this setting. It is based on the Directive 2006/48/EC, Article 131, according to which [...] *"the competent authority responsible for supervision on consolidated basis and the other competent authorities shall have written coordination and cooperation agreements in place."* Supervisors cooperate and share information on the basis of the Memoranda of Understanding. These memoranda are bilateral and legally non-binding agreements. In the case of home country supervision, supervising authority has to provide information to the host authorities that are responsible for systemic stability. In the case of subsidiaries, home country supervisor, who is supervising the parent bank on consolidated basis, relies partly on information obtained from the host country supervisors. Besides information sharing there are some issues that are solved between home supervisor and subsidiary in the host country and *vice versa* despite formal model of supervision. Differing requirements and duplicity of supervision imposes large compliance costs burden on banks. Padoa-Schioppa (2004b) mentioned that the HSBC bank spends 400 million USD yearly on complying with various regulatory

requirements. It represents 3% of its pre-tax profits.[20] De Larosière Report (2009) mentioned 1% of operating expenses to be the compliance cost for large banks and financial conglomerates.

2.2. Corporate Structure

"I do not believe you can do Today's job with Yesterday's methods and Be in business Tomorrow."

Nelson Jackson

Cross-border activities of banks can be structured in three different ways – subsidiary structure, branch structure and most recently *Societas Europaea* structure. Primary organization structure is to establish a subsidiary abroad. Subsidiary refers to the least tight link between mother and daughter banks. It can be perceived as equity participation only. Liability of the parent bank as a majority shareholder is limited. However, issues of reputation and reputational capital cannot be neglected in this case. Cerutti et al. (2007) pointed out that HSBC, Banco Espiritu Santo, ABN Amro and KBC banks did not let their subsidiary banks go bankrupt. On the other hand, Citibank, Crédit Agricole and Bayerische Landesbank banks did not help their troubled subsidiaries. Subsidiary is perceived as a local bank in a host country, hence it is supervised by host authorities, as was already mentioned, and has to use the deposit insurance scheme of the host country.

Another type, a branch structure, refers to a tighter link, since branches are not separate legal entities. They are operating under banking licence of the parent bank and they are supervised by home country authorities. In this organizational structure, mother bank cannot refuse to help its branch with the exception of ring fencing provisions. Losses caused by wars, civil conflicts or interventions of host country governments are limited in this case as well. In the case of branches, the top up principle allows branches to use the host country's deposit insurance scheme, if the coverage is higher in the host country than in the home country.

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[20] Figure is likely to be higher than in the case of other European banks, since the HSBC bank operates worldwide and overseas activities are considerable.

The Regulation 2001/2157 allowed existence of the *Societas Europaea* companies, i.e. companies operating under community laws. *Societas Europaea* status is available for credit institution as well. They can operate under single legal framework[21] in all countries of operation, where they establish branches. The only relevant case so far has been the Nordea group. Nordea group is a banking group operating mainly in the Nordic and Baltic countries. It announced a reorganization and adoption of *Societas Europaea* status. At the end of the transformation, there is a vision of operation under Swedish law pursuing business in Denmark, Finland, Norway and Poland through the branches.[22] Despite the branch organization, these branches are of systemic importance in Denmark, Finland, Norway and Sweden as illustrated in Chart 5.[23] Operation of Nordea under the regime of *Societas Europaea* means that subsidiaries which were supervised by host countries are supervised by Swedish authority after the conversion to branches, i.e. home country supervision principle is applied.

Chart 5: Nordea's market share in the Nordic countries

	Denmark	Finland	Norway	Sweden
Mortgage lending	17%	32%	12%	16%
Consumer lending	15%	31%	11%	9%
Personal deposits	22%	33%	8%	18%
Corporate lending	19%	35%	16%	14%
Corporate deposits	22%	37%	16%	21%
Investment funds	20%	26%	8%	14%
Life & pension	15%	28%	7%	3%
Brokerage	17%	5%	3%	3%

Source: Mayes (2006)

Following Dermine (2005), there are arguments for each of the structures. However, the paper concludes that following the pure branch structure is a myth at the moment, because advantages of the subsidiary structure are much higher than those of the branch structure. In this summary, possible moral hazard problem is the reason for

[21] In fact, not only the EU law, namely Council Regulation 2001/2165 and Council Directive 2001/86/EC, but also law of the particular member state and various bylaws apply, as Dermine (2005) pointed out.

[22] Nordea operates in Baltic countries via branches of Nordea Bank Finland Plc. See Annex 2 for organisational chart of Nordea Group.

[23] Nordea is of systemic importance in Estonia operating as a branch as well. However the problem did not occur by adoption of *Societas Europaea* status, since it was run as a branch of Nordea Bank Finland Plc.

subsidiary scheme.[24] The paper points out that the *Societas Europaea* structure is more favourable than the branch structure as well.[25] Few years later, we witness the reorganization of the Citibank in Europe, which used to operate under the subsidiary scheme and nowadays it moves to the branch structure.[26] Explanation can be found in Cerutti et al. (2007). According to the paper, branches are established especially in countries with higher corporate taxes, and they face lower regulatory restrictions on banks entry. By contrast, subsidiaries are preferred for the purpose of obtaining large market share in retail segment which is not the case of Citibank Europe. Business structure and profile of a bank seems to be of highest importance with respect to the above mentioned points. It is obvious that in the case of transition countries privatization of the existing banks affected organization structure as well. According to Mertlik (2009), in some privatization projects there was a precondition for all investors in the process of privatization to keep the subsidiary structure.[27]

From a policy perspective, it is obvious that, since risk matters, parent banks should be expected to behave differently vis-à-vis branches and subsidiaries in times of economic and political crisis (Cerutti, 2007). If one of the organization structure is perceived to be better than other structures, banks will be encouraged by supervisors to adher to this structure. There are three basic differences mentioned - supervising institution, limited liability and deposit insurance - which are not the same in all cases.

From a perspective of the supervising institution, one can conclude that authorities prefer to supervise banks by themselves, therefore subsidiary structure is preferred. In the case of a limited liability, branch structure will be preferred, since only in the case of the already mentioned exceptions the parent bank can refuse to rescue its subsidiary. With respect to the deposit insurance, branches can choose higher level of deposit guarantee, therefore not to choose the home country deposit insurance scheme, if it is lower than the host country scheme. In such a case, problem of accountability

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[24] Limited liability of shareholders and asymmetric information between shareholders and debt holders allows for expropriation of debt holders and insurers by increasing the riskiness of assets, i.e. risk shifting. Subsidiary scheme hinders risk shifting. For other reasons such as managerial resistance, public trading, corporate taxes, etc. see Dermine (2005).

[25] Corporate efficiency, reduction in operational risk, transparency, reduction of the VAT, and efficient use of capital are the advantages discussed by Dermine (2005). Dermine discussed also problems, which should be solved regarding deposit insurance.

[26] Citibank Europe plc covers activities in Europe; subsidiaries in the Czech Republic, Hungary, Romania and Slovakia have changed into branches most recently.

[27] In fact, preconditions and the following agreements are more restrictive. Owners are not allowed to change the name of the banks as well. Mertlík (2009) mentioned that it is the case of Česká spořitelna (owned by Erste Group), Československá obchodní banka (owned by KBC Bank) or Komerční banka (with majority stake in hands of Société Générale) in the Czech Republic.

arises. Branch is supervised by the institution abroad, but uses a deposit insurance of the country, where it operates. Deposit insurance fund has no means how to control the risk of the bank whose clients it insures. As was already mentioned, choosing the form of corporate structure is important especially for the new member states´ supervisory authorities, since the market share of the foreign owned banks is large and usually systematically important banks are foreign owned as well.

2.3. Problems of current supervisory structure

"The French supervisor oversees French subsidiaries, the German supervisor oversees German subsidiaries and no-one has the full picture of the major EU-wide banking groups. This supervision is neither 'super' nor 'vision'"

Thomaso Padoa-Schioppa

Current home-host supervisory structure has different approach to financial institutions following their legal form. No doubt that there are good reasons to do so, especially tax reasons. However, practical differences among banks operating via subsidiary and branch structure are limited, or can be reversed as well.[28] A subsidiary can be integrated to the parent bank much more tightly than a branch of other bank. Should it happen, the host country will supervise a subsidiary actually managed from abroad, while home country will supervise a branch run by a local management of the host country. It is in contrast to the attitudes of practitioners in the field of banking supervision, to quote Ingves (2007): "It is only when the framework for regulation, supervision and crisis management match the actual structure of financial markets, that the negative externalities of financial crisis can be managed properly." Mayes (2006) therefore suggests matching supervisors according to the reached level of integration within a bank. However, such a demand is hardly applicable in practice and means an uneven playing field on the market. If one considers whether today's supervisory setting creates level playing field, the answer is no. Market players are supervised by various supervisors. They face uneven requirements[29] and use different deposit insurance

[28] See inter alia Mayes (2006) and Schoenmaker and Oosterloo (2008), who refer to the risk management and other issues that might be centralised in subsidiary-organized banks, even though they are not centralised in some banks operating via branch structure.
[29] See Chapter 1.1 for an example of differences in perception of the core capital.

schemes. There is no level playing field for market participants. The expected competition among the EU countries´ frameworks serves as an excuse.

Home country principle applied in the EU means that the national supervisory bodies are responsible for the supervision of banks on the consolidated basis, i.e. for the supervision of domestic banks and their foreign activities. Such a supervisor has a domestic mandate and is accountable for the systemic stability in its own country only. Therefore, potential negative cross-border spill-over effects might be neglected. Informational asymmetry might hinder the effort of national supervisory authorities to deal with cross-border effects – import and export of contagion, if they are motivated as well (Schultz, 2002). It is obvious that from the supranational point of view such supervision is suboptimal. Macro-prudential issues turned out to be the biggest problem of supervision. De Larosière Report (2009) contains a criticism of neglecting the cross-border contagion and negative spill-over effects by the supervisors as well.

In order to achieve optimal supervision, cooperation and coordination of activities is needed. Information sharing and cooperation under the Memorandum of Understanding are the usual tools how to deal with it in the EU. Their legally non-binding nature is problematic since no enforcement is possible should failure happen. Holthausen and Rønde (2004) investigate the use of the Memoranda of Understanding under the branch structure setup and find reasons why it is not sufficient. They point out that "hard data" from balance sheets are easily transferable, but "soft data" not contained in balance sheets are usually not transferred sufficiently. Moreover, motivation of supervisors can differ with regard to specific cases. Reasons for closing or not closing of a bank can differ in two countries, if the bank is systemically important in one of them, but not in the other one.

The Memoranda of Understanding are likely to lead to opportunistic behaviour and moral hazard. Systemic importance in the counterpart's country is likely to create moral hazard. A supervisor is reluctant to help the troubled bank and relies on the intervention of another country. Situation of supervisors in this case is a typical example of prisoner's dilemma, to use the methodology of a game theory. In such a case, it is obvious that the result of a game consisting of intervention and forbearance will be the forbearance of both supervisors. In the case that both countries are reluctant because of the same reason, a troubled bank might go bankrupt, as was already illustrated in Box 1. In the case of branches, reluctance of the host country supervisors (or other authorities) might be augmented since they are not accountable for such a bank and leave the burden

on the shoulders of the home country's supervisor. As Mayes (2009a) points out, in fact, closing of a bank is the only viable solution if the bank operating via branches is in troubles and the domestic country is not willing or able to bail it out. Goldberg et al. (2005) go further and mention that within the home-host country setting home supervisors have an informational advantage. In case of a distress they might not inform the host country supervisors and thus allow for transfer of losses to host country subsidiaries or for removing of assets from a subsidiary to a parent bank while letting the subsidiary go bankrupt if a really serious problem occurs.[30]

Box 1: Memoranda of Understanding during the financial crisis

Cooperation of supervisors under the Memoranda of Understanding had not been criticized before the crisis started, but it was not the primary issue because emergency steps were not needed. Situation changed as soon as financial crisis appeared. Dendooven (2009) described the rescue of the Belgian based Fortis bank with significant market share in Luxemburg and the Netherlands as well. He pointed out that information had not been reported properly and each of supervisors had been waiting for other supervisors to start with the rescue of the bank. Hertig et al. (2009) concluded the same in the case of French Dexia bank operating also in Belgium and Luxemburg. In both cases, the banks were very close to collapse due to the supervisors´ reluctance to start solving the problem. Lanoo (2008) points out that operation under the Memorandum of Understanding might be problematic even on the national level, as illustrated on the case of Northern Rock bank and the cooperation of the Bank of England and the Financial Services Authority under the Memorandum of Understanding, see Box 2.

Current supervisory setting has proven to be delayed, which is however not only due to the Memoranda of Understanding. It is because of the general lack of prompt corrective actions in the EU. Currently, supervisors usually start to deal with a bank

[30] Goldberg et al. (2005) did not specify the methods how to shift assets or losses from one entity to another. Besides genuine tunnelling methods, one can think of toxic assets being switched for non-toxic ones, but practitioners of these practices are probably far more sophisticated.

when problems have already gone too far. Mayes and Wood (2008) point out that the supervisors should have stepped in the Northern Rock bank few months earlier than they did. If the bank operates in a cross-border manner, delays are even worse (Mayes, 2009a).

Box 2: The Northern Rock case

In summer 2007, problems in the Northern Rock bank occurred. From today's point of view, it is clear that the Northern Rock bank had rather liquidity than solvency problems. The House of Common's Report (2008) pointed out that the problem could have been solved and bank run avoided, if the reaction of the Financial Services Authority (FSA) had been prompt. Mayes and Wood (2008) add that the FSA had been informed about the situation of the bank much sooner than the bank run started. They refer not only to the failure of FSA but to the failure of the cooperation of the authorities. Trust is very important in the banking sector and once it was believed that the Northern Rock was insolvent and authorities did not send a clear signal, it was a difficult task to regain trust of the market. One might conclude that when powers and responsibilities are divided non-transparently, then the reaction is delayed, as was documented in Box 1 as well.

Currently used deposit insurance can create further diversion in intensions of supervisors. Failure of the transmission of information within the framework of the Memoranda of Understanding occurred during the financial crisis and was described ex post (*inter alia* De Larosière Report, 2009; Frait, 2009). However, there were also neglected ex ante warnings, that information sharing would not work, and calls for strict rules with a mechanism to enforce them, see *inter alia* Freixas (2003), Schoenmaker and Oosterloo (2005).

2.4. The Lender of Last Resort and Deposit Insurance

"He who pays the piper calls the tune"

British saying

Solvency problem is the last phase. Liquidity problem occurs earlier and not necessarily leads to a solvency problem. It is worth discussing whether external parties are able to distinguish between a pure liquidity problem and an early stage of a solvency problem due to the information asymmetry (Boot, 2007).[31] If solvency problem is expected to follow that of liquidity, such bank should end up in bankruptcy, if no private solution (take-over) prevents bankruptcy, not taking into account banks that are too big to fail, as these will be bailed out by the government.

If a bank faces liquidity problems and it is not necessarily an insolvency case, it might be caused by poor liquidity management or some external shock or bank run.[32] According to Padoa-Schioppa (2004a), assuming mature interbank markets, pure liquidity problem should be only a textbook example. It might not, however, be the case of a global crisis. When some external shock occurs, interbank market as a source of liquidity can be suspended and otherwise solvent bank may end up in bankruptcy.[33] The lender of last resort or emergency liquidity assistance (ELA)[34] aims at preventing such development. There is something special about ELA in the EU, since national central banks are responsible for the liquidity provision to illiquid banks in the single monetary jurisdiction (Schinasi and Teixeira, 2006). There is no centralised approach on the European level.

Schinasi and Teixeira (2006) discussed the problems of the ELA provision on the case of illiquidity of a large bank operating Europe-wide, because it is not clear who is ultimately responsible for providing of the ELA in such a case. Should home country principle be applied, i.e. central bank of the country where parent bank is established provide ELA for the whole group, or should central banks of all involved countries provide ELA for the respective banks depending on liquidity needs of each entity? There might be arguments in favour of the former option, highlighting centralised

[31] The Northern Rock case is an example of a case when external parties did not evaluate the situation correctly.

[32] Traditional view following Diamond and Dybvig (1983)

[33] Recent view based on Rochet and Vives (2004)

[34] Both terms are interchangeable. Both terms express individual liquidity assistance to the illiquid banks.

liquidity management and supervision on the consolidated basis in the home country. Since liquidity problem is a problem of whole group, it should be solved jointly and parent bank would distribute liquidity to the group under this view. However, it would mean that one country will potentially absorb all the credit risk with impact on the taxpayers in this country. This is one of the reasons why national central banks are responsible for ELA instead of ECB. Engagement of the ECB would not be covered by fiscal powers on the European level (Boot, 2007).

Accountability issues, neglecting the cross-border externalities and the moral hazard as described in the previous chapter, are at least as important when considering ELA provisions. Banks with liquidity problems might therefore end up in a similar way as the troubled banks mentioned in the previous subchapter in spite of the temporary nature of their problems, which might be caused by some external event. Cooperation is much more difficult, since central banks are not responsible for supervision in all countries, hence they have to gain the information from supervisors. Cooperation in the case of a multinational bank is therefore more than complicated. Padoa-Schioppa (2004a) opposes that Eurosystem is capable of action and there is no need for doubts. Contrary to critics, he considers this *constructive ambiguity*[35] to reduce moral hazard. Financial crisis largely confirmed the stance of Padoa-Schioppa. The ECB provided enough liquidity to resuscitate interbank market, hence it provided liquidity for all banks facing liquidity problems. Situation was "unique" in the sense that banks in all Eurozone countries were facing a liquidity problem. There was a consensus that more liquidity in the market was needed. Prior to the event, Boot (2007) had pointed out that ECB would step in according to the Article 105 (2), Chapter 2 of Maastricht Treaty,[36] and quoting the first ECB president, Duisenberg. It is not clear how a liquidity problem will be solved in the case of a single multinational bank's liquidity problem that will not be perceived as a serious threat for the financial stability. Position of the ECB is not clear, since on one hand it can provide ELA if needed, but it can also sterilize the ELA of national central bank, should it endanger price stability (Scacciavillani et al., 2002; Schűler, 2003).

To conclude the debate above, the Eurosystem did not fail with respect to the ELA provision. However, due to the nature of the crisis, one cannot conclude that ELA

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[35] The expression comes from Garry Corrigan, quoted in Padoa-Schioppa (2004).
[36] Where one of the basic tasks of the ECB to be carried out through the ESCB is "*to promote the smooth operation of payment system*"

will work in all cases and one cannot conclude that ELA provision will be effectively provided in a case similar to the Northern Rock case. Moreover, despite the Padoa-Schioppa's support of the *constructive ambiguity*, he did not deflect the critique that market participants might consider the ELA framework inadequate, what would push up risk premiums. Market's perception of the adequacy of the ELA provision is worth deeper analysis in order to learn whether *constructive ambiguity* approach or clear *ex ante* rules should be preferred in this case.

In the European financial supervision model, deposit insurance is based on the national level. Deposit insurance can be perceived as a passive institution, more or less just as a fund collecting money for the case of need. Both points are worth further discussion. Since it is nationally based, it creates impediment for integration of the supervision, based on non-national level. Goodhart and Schoenmaker (2006) see the problem of integration or division of supervision in conjunction with fiscal competence to deal with problems when they occur. As they argue, a bank will be bailed out if social costs of the bank failure with all consequences exceed the costs of recapitalization on national level. However, the bank will go bankrupt despite social costs of failure being higher than costs of a bailout, if viewed on supranational level. Moreover, costs of saving of a large multinational bank can be too high in comparison to the fiscal resources of the country, or as Goldberg et al. (2005) refer, the bank may be too big to save.[37] Therefore perfect supervision without associated fiscal competences will result in suboptimal solution as well. Dermine (2005) adds the international accountability issue to the debate. According to him, country that exerted supervision poorly should bear the costs of bank failure.

Separation of supervision and costs associated with bankruptcy of credit institutions create incentive problems for supervisors with treating the problematic banks immediately. If the deposit insurance fund is also the supervisory authority, such as the Federal Deposit Insurance Corporation (FDIC) in the US, the incentive to minimise costs is already incorporated, see *inter alia* Goodhard and Schoenmaker (2006) or Mayes (2006). Mayes (2006) considers the deposit insurance arrangement to be the reason why the US system cannot be transposed to the EU and calls for creation of a European equivalent of the FDIC. However, he points out that in case of a large multinational bank perceived to be too big to fail, the existence of this institution may

[37] Keeping in mind high level of government debt of old EU member states

not be enough. Goodhard and Schoenmaker (2006) therefore go further and propose creation of a special fund to solve these problems, should they happen.

2.5. Conclusion

"Experience is a good school, but the fees are high."
Heinrich Heine

Current supervisory arrangement based on the division of supervisory responsibilities between home and host country supervisors and their cooperation have been proven to be problematic at least. Since requirements differ slightly at least, there is additional burden imposed on the credit institutions. Cooperation is crucial under this setting. However, it is based on the legally non-binding agreements. Since supervisors have a national mandate and responsibility to maintain financial stability of their own country, opportunistic behaviour is very likely to occur. Especially during the crisis it turned out to be inadequate. Supervisors did not share information with their counterparts and did not cooperate on the rescue of troubled banks.

Home-host supervision of banks follows the legal status of the credit institution, not its operational structure. Moreover, such a distinction creates an uneven playing field for market participants - two credit institutions operating in the same country might use different deposit insurance, or obey more benevolent requirements of supervisors due to the lack of harmonization of rules, the core capital rule might serve as an example. Credit institutions are usually free to change the legal structure. If an institution of a high systemic risk importance changes its legal structure and uses branches instead of subsidiaries, the host country supervisors will only be in the role of spectators, not guardians of financial stability. Moreover, supervision is linked to no fiscal responsibilities and means. There is a clear problem of accountability on national as well as international level. The rescue of a problematic subsidiary of a multinational bank will be an extremely difficult task.

3. New supervisory framework

"Failure is simply the opportunity to begin again, this time more intelligently."

Henry Ford

In previous chapter I have concluded that the current supervisory framework for a supervision of credit institutions in the EU is not suitable for the current state of the banking system in the EU. Many of the problems stem from different requirements of national supervisors and their unwillingness to harmonize rules and/or to cooperate. The home-host principle following a legal structure seems to be impropriate since operational structure differs to legal structure. During the financial crisis we have witnessed failures in cooperation and coordination of national supervisors with regard to solving of problems of troubled credit institutions. The fiscal responsibility is not solved sufficiently; therefore it should be addressed as well.

In this chapter the attention will be shifted from description of past development, current state and discussion about problems of current setting into future challenges. The challenges are connected to the issues of new regulatory and supervisory framework. This chapter will be organized as follows. First subchapter presents basic principles for regulatory and supervisory framework stemming from the lessons, which we have learned. The principles are rather supratemporal, they do not reflect the latest financial crisis only. We will present the criteria upon which different proposals should be evaluated. Section two will present various proposals which emerged in past years, analyse them and evaluate them according to the criteria. Third subchapter compares the frameworks of the EU and the US. It rather points out the reasons why the US framework is transposable. Fourth subchapter concludes.

3.1. Principles for the European supervision

"Supervisory structure should [...] adapt to market developments and not the other way around"

Dirk Schoenmaker and Sander Oosterloo (2008)

3.1.1. Integration versus cooperation

In chapter one, we have shown, that the wholesale market is fully integrated, while the retail market is still more a local business. The trend shows that also in the retail market, cross-border activities are gaining importance. Another trend is a centralisation of the risk management functions (Schoenmaker and Oosterloo, 2008). In chapter two, we have shown the problems of cooperation among supervisors within a single country and across countries. Both groups of authors, those advocating deeper cooperation and those asking for integration of supervisors, accept the view of deficient cooperation under the legally non-binding Memoranda of Understanding.

However, those, advocating deeper cooperation argue that the problem is caused by the legally non-binding nature of the Memoranda. They state that it is not caused by the philosophy that banks should be supervised by national supervisors and in the case of multinational banks supervisors should cooperate. This philosophy says that the majority of banks are still local, therefore proximity is very important. Only the minority of banks are operating cross-border and cooperation can be achieved upon legally binding agreements. Accountability issues are important as well. There is no EU budget for potential bailouts. Domestic supervisors should be accountable for the banks bailed out with taxpayers´ proceeds in a particular country.

On the other hand, the supporters of some form of the European supervisor argue that the aim is to create the Single Market. Further, the wholesale market is already fully integrated, the interbank market can be a source of potential negative cross-border spill-over effects, and thereby it already makes sense to consider the European market to be a single integrated market. Therefore, common comment for the creation of the European structure of supervision is *"that it might be difficult to achieve simultaneously a single financial market and stability in the financial system, while preserving a high degree of nationally based supervision and crisis management with only decentralised effort at harmonisation"* (Thygesen, 2003). Moreover, they argue that in spite of the fact that most banks are still domestic, those operating cross-border are more important and create higher potential for systemic risk. Regarding accountability issues, missing European fund to cover possible bail-out costs is perceived as a temporary state, which should be solved in the future as well.

When one compares both approaches, the cooperation of supervisors is less legible for market participants. In the case of the legally non-binding Memoranda the cooperation might be illegible at all. The creation of expectations is important as an *ex ante* corrective for bank management. Moreover, clear *ex ante* rules are important to preclude panic and bank runs. In chapter two we have already illustrated impact on the Northern Rock bank. Guttentag and Herring (1987) pointed out that in some cases bank runs can not be terminated by an *ad hoc* intervention, if credibility was already lost. They refer to the Continental Illinois bank case. Despite the effort of the US authorities, who guaranteed all deposits during the bank run, followed with 1.5 billion USD capital injection of the FDIC, 0.5 billion USD capital injection of the group of commercial banks, 5.5 billion USD credit line from commercial banks and commitment of the Federal Reserve to provide unlimited liquidity, the bank run was not terminated. The bank did not regain a confidence until the *de facto* nationalization took place.

With the respect to the above mentioned facts and with the respect to the financial crisis, most of the proposals suggest further integration of the European banking supervision and creation of some centralised body. Minority of the proposals suggest deepening of cooperation and coordination within the current home-host system. Some proposals go further, asking for a worldwide banking supervision, but such projects are not likely to be implemented.

3.1.2. Unified versus two-tier supervision

Market players are of different size and have different radius of operation. Most of banks are still domestic, operating in one country only. They are followed by many regional banks, operating in two or few countries. There are only few large multinational banks that operate in all or most of the EU countries. However, Papademos (2005) concluded that 14 largest banks account for one third of total banking assets in the EU. Differences among banks in their size and range of operations lead authors of various proposals to the two-tiered supervisory approaches. It implies maintaining of the national supervision for local banks while adopting some form of integrated supervision for the pan-European banks.

Problem of all two-tier systems is that it is not clear how to sort banks in two groups – multinational and national ones. There are many banks operating in more than

one country, but still too small. When considering large multinational banks, we are taking into account 30 to 50 financial institutions in the EU.[38] Another problem of two-tiered systems in comparison with unified is that conditions for market participants would be uneven. It is not acceptable for many economists and politicians as well. When concerning equality, in chapter two, we have concluded that the current home-host country supervision is the case of unequal treatment on the market as well. It is due to the differing requirements of supervisors in home and host country. Such inequality is easier to be accepted since it is a general principle not division set arbitrary. Of course picking tens of banks to be supervised on the European level can be based on some general principles as well; however there will be still difficulties to accept.[39]

Some authors as *inter alia* Carmassi (2009), Mayes (2006) and Stern and Feldman (2004, 2005) pointed out that these banks should be supervised in different manner than other because of too big to fail status. Tougher supervision is justifiable since these credit institutions (or financial conglomerates) benefit from the perception of being too big to fail and expectation of a bail-out hence lower costs of funding. This view suggests that such framework narrows the market.

3.1.3. Legal framework demands

The proposals can be divided also with regard to the intensity of legal framework's changes. Authors usually take into account difficulties to face if change of the legal framework will be needed.[40] Therefore Hertig et al. (2009) proposed an integration of supervision within the framework of the Maastricht treaty. However,

[38] Schoenmaker and Oosterloo (2005) suggest 30, Padoa-Schioppa (2004) suggests 40 and Srejber and Noréus (2005) slightly more. Let it be 30, 50 or more, the dividing line will be set arbitrary, since no clear rule for distinction is to be implemented. For the methodology of the identification of a systematically relevant financial institution, see Carmassi (2009), who provided broad overview of proposed methods of identification and discussed them. According to Lannoo (2008) the threshold of the EU merger control regulation can function as a dividing line between national and regional banks one hand and multinational banks on the other hand.

[39] Especially in the EU, where decision making procedure is far from being simple, such attempts are easy to be blocked.

[40] It is questionable whether EU can move towards homogeneous framework, since only regulations are automatically part of the frameworks of all member states. All directives have to be transposed by national law-makers and the process of transposition usually leads to the differences among member states and is the cause of heterogeneity. De Larosière Report (2009) pointed out that in the case of strict transposition various interpretations are possible as well, what amplifies the problem.

overwhelming majority of the proposals assume that changes of the legal framework will be needed, at least to some extend.

Mayes (2006) analysed the framework for financial supervision of ideal world, meaning homogeneous regulation. Under the conditions of homogeneous legal framework, he pointed out, that supervision usual for a national level will be suitable for an international i.e. the European level in our case as well. However, some division of powers will be needed due to the organisational reasons, to make the system manageable. Mayes therefore proposed supervision of local banks by local representatives, while multinational banks would be supervised by the Europe-wide supervisor. This approach is similar to the Italian model of financial supervision. Mayes, himself, looks on this concept as a wrong approach to the solving of the problems of the supervisory structure. Of course, we do not live in an ideal world and it is not likely that we will soon, despite the efforts to integrate national markets to the European one. The idea to analyse a framework for this Mayes´ ideal world might seem pointless, but it provides us with important insights, since we know the differences between real and ideal world.

For the European level, the insight of Mayes as such is interesting with regard to *Societas Europaea* status and particularly for the existence of the Nordea group, the first banking group to adopt this legal form. The framework under which it operates is homogeneous. Holthausen and Rønde (2004) analysed why supervision on a national level will be suboptimal in the case of this group.

Padoa-Schioppa (2004a,b) looks on the problem of homogeneity of the legal framework from the different point of view. He does not consider the creation of such environment with the view to promote another supervisory structure *per se*. He considers further integration to be a tool substantially reducing costs of compliance for financial institutions operating in more than one country. This view is in accord with the view presented in Chapter one, where we have pointed out, that regulatory framework is heterogeneous what is a source of inefficiency and creates huge compliance costs for banks. This view was accepted by the De Larosière Report (2009) as well. Since compliance costs are transferred to customers, lowering the costs for customers could motivate legislators to exert much more effort to create homogeneous legal framework for the EU and national legislators to transpose the legislature in the EU member states.

In a longer time horizon this debate about ideal world with a homogeneous legal framework in the EU hence supervision for homogeneous market might seem more

realistic. The question is, whether policymakers consider the legal framework to be time invariant or whether they admit a need for changes in the legal framework to enhance *inter alia* supervision. If sooner is true, they must be looking for an instant form of a supervisory structure immediately available and able to work under current legal framework.

3.1.4. Summary

To sum up above discussed differences in proposals, they can be divided by the intensity of change. While some of them are revolutionary, other proposals are evolutionary. We would like to put a stress on the attitude of Schoenmaker and Oosterloo (2008) and set their attitude to be a basic principle for changes in supervisory framework: *"supervisory structure should [...] adapt to market developments and not the other way around."* Hence, evolutionary proposals taking into account importance of the path-dependency principle, understanding the difficulties of institutional changes especially in the EU and need for robust institutions will be perceived to be superior to the proposals normative, taking place in a vacuum, neglecting historical time and needs of institutional stability. Another important feature of the proposal which will be advocated is legibility of the concepts towards market participants. Transparency means that expectation of market participants should be unambiguous. Clear *ex ante* rules will be perceived to be superior to ad hoc interventions and corrections.

In previous chapter we have described the problems of current supervisory and regulatory framework. Cooperation of supervisors under the legally non-binding Memoranda of Understanding turned out to be insufficient, due to the incentive problems and differing objectives of national supervisors. Taking the problem from broader perspective as a debate about a national versus European supervision, one should take at least one hindsight from the latest financial crisis. As Carmassi (2009) pointed out, supervision is still based on a local micro-prudential basis. It reflects historical development when financial systems were rather closed. However, financial systems became more interconnected and as Carmassi pointed out source of risks changed due to the use of various novel financial instruments. If risks connected with banks´ operation have changed, supervisory framework should take them into account. In chapter 1.2 we have concluded that the wholesale market is fully integrated while

retail is still fragmented. Padoa-Schioppa (2004a) has already pointed out that if market risks are connected with integrated markets (single market) then also supervision should move to the European level.

Legal structure of banks differs from organization structure and results in a mismatch of supervisory and organizational structure of banks. The problem of accountability arises due to the separation of supervision and deposit insurance. When concerning the ELA provisions, situation is the same with the only exception that the latest financial crisis did not test the ELA provisions due to the prompt liquidity injection of the ECB. Supervision of multinational banks with systemic importance in more than one country is another problem under the current setting. In next subchapter we would like to discuss other possible arrangements proposed so far. We will use generally accepted criteria originally proposed by Schoenmaker and Oosterloo (2005) augmented by the deposit insurance and public spending related issues. Despite the fact that this part will be considerably based on the paper of Schoenmaker and Oosterloo (2005) different proposals will be evaluated.

Criteria originally proposed by Schoenmaker and Oosterloo (2005) are as follows:

1. Effectiveness of supervision
2. Efficiency of supervision
3. Financial stability
4. Competitiveness of financial institutions
5. Proximity to financial institutions

Effectiveness of supervision is perceived as an ability to supervise financial institutions on the consolidated basis as a whole and to be able to supervise all parts of their business. This is important especially with the respect to the multinational banks, not as much regarding local players where the supervision is perceived to be effective. Efficiency of supervision means that institutions will be supervised by one supervisor only, duplicity in supervision will not occur. One might consider this problem to be of a minor importance, only as a problem of time consumption, or even think about enhancing effectiveness by doubling the supervision. However, Basle Committee on Banking Supervision (2003, 2004) and Mertlík (2009) from the experience from Czech Reiffeisenbank suggest that duplicity of supervision might lead to diverging or even opposite requirements of supervisors. Considering the financial stability, cross-border

externalities and possible contagion should be taken into account. In other words, this criterion will be fulfilled if the financial stability of all countries concerned will be protected. Criterion of competitiveness expresses the need to create a level playing field for all institutions concerned and not to create additional burden on them. The rationale behind the last point, proximity to financial institutions, is the belief that supervisors endowed with local knowledge can better supervise financial institutions.

3.2. Proposals for a new financial supervision

"If two men on the same job agree all the time, then one is useless. If they disagree all the time, then both are useless."

Darryl F. Zanuck

The criteria set in the subchapter 3.1.4 will be applied on following proposed supervisory models: structure similar to the Italian supervisory structure proposed by Padoa-Schioppa (2004b), the European System of Financial Supervisors proposed by Schoenmaker and Oosterloo (2008) and the Choice-based approach proposed by Hertig et al.(2009). They will be compared to five supervisory models originally evaluated by Schoenmaker and Oosterloo (2005). In total, there are 8 models to be evaluated:

1. Choice-based approach (Hertig et al., 2009)
2. European System of Financial Supervisors (Schoenmaker and Oosterloo, 2008)
3. Italian structure (Padoa-Schioppa, 2004b)
4. Home-host structure (current)
5. Home on the national basis
6. Home on the European mandate basis
7. Central European supervisory body
8. Host on the national basis

The choice-based approach is a conditionally centralized approach, what means that countries can both opt-in and opt-out for the ECB supervision. It will be described in detail in subchapter 3.2.1. The European System of Financial Supervisors is a combination of centralized and decentralized components. It means a creation of a centralized body, but still leaving part of competences on a national level. It will be

described in a detail in the subchapter 3.2.2. The Italian model is a centralized model with decentralized fragments. Transposition of the Italian model on the European level will mean division of credit institutions to those being supervised by a central body and those being supervised on a national level. It will be discussed in a detail in the subchapter 3.2.3.

The rest, i.e. the models originally evaluated by Schoenmaker and Oosterloo (2005) will be discussed in subchapter 3.2.4. The home-host structure means that home country supervises a financial institution and its branches. Host country supervises subsidiaries only. It is already extensively described in chapter two. Therefore it will not be discussed in detail again. Last four models will be discussed briefly. The 'home on the national basis' structure expresses the principle, that home country supervises activities of the whole financial group i.e. both its branches and subsidiaries. Supervisor is responsible for needs of home country. The "home on the European mandate basis" structure is rooted on the same principles, however with the responsibility for all countries involved. Central European supervisory body clearly means a creation of a single supervisor responsible for the whole EU. The "host on the national basis" structure means that all financial institutions will be supervised in the country, they operate.

3.2.1. The choice-based approach

The choice-based approach was proposed by Hertig, Lee and McCahery (2009, HLM from now on). Under this approach, the EU member states are able to both opt-in and opt-out for the ECB supervision. It means that country that opted-in may delegate supervision of the multinational banks to the ECB and keep supervising other banks. Therefore, it is a proposal for a two-tiered supervisory model. This approach is very interesting indeed. HLM mentioned many advantages of this proposal, let us briefly sum them up. This proposal is designed for the supervision of multinational banks operating EU-wide.[41] It is based on the agreements between the ECB and respective member states. Bilateral agreements allow for flexibility, they can be tailored to respect country specific needs.

[41] They assume 50 banks to have this status.

The article 105 (6), Chapter 2 of the Maastricht Treaty provides a legal basis for this proposal: *"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."* Since the approach is choice based, there is no need for an agreement of all member states, therefore execution is much easier. However, as the Article 105 (6), Chapter 2 of the Maastricht Treaty states, unanimity is needed to allow the existence of the model. Only then countries will be able to opt-in on the case by case basis. Nevertheless, one can agree with HLM, who consider this to be the most important advantage *vis-à-vis* other proposals.

Assessment according to the criteria: 1. Authors suggest that this approach is more effective then the current setting. In fact, a supervision of majority of banks would stay unchanged. The debate is only about 50 largest banks where the ECB supervision would replace supervisors of the countries that opted-in. Thereby fewer supervisors will have to cooperate. Supervision of these institutions would be therefore more effective. However, if only few countries will opt for the ECB supervision, it will reduce the number of supervisors which have to cooperate only slightly. 2. The problem of duplicity is limited to some extend by better coordination. 3. Financial stability would be improved substantially since banks supervised by the ECB would be those of a systemic importance and the ECB would have a duty to take into account financial stability of all countries. 4. Establishing a system with differentiated approach to the banks according to their size would violate the principle of level playing field for all participants on the relevant market.[42] 5. Large credit institutions, themselves, are willing to integrate the supervision, to have counterpart of same size so this criterion is fulfilled.

Main problems of this proposal are as follows. Some countries, where top 50 banks do not operate or are not of systemic importance, as in Slovenia, or Baltic countries, would not feel the difference therefore their willingness to join is limited. According to the proposal, countries are always able to opt-out. Unstable institutional framework might be a result. Opting-in or opting-out depending on a political cycle in countries is indeed wrong signal despite the fact that HLM suggest that arrangement is advantageous for all countries in the example. Another problem is that opting-in of one

[42] For justification of such differentiation see subchapter 3.1.2.

country will affect activities of the banks abroad as well. HLM mentioned that *"the agreement will thus have to take into account its pan-European impact"* without concrete provisions. HLM pointed out that country opting-out in case that opting-in will turn out to be a mistake has nothing to loose. In post-socialist countries we have witnessed that building new supervisory institutions is not as easy as one can think. HLM therefore neglect the institutional stability issues and the process of institutions changes.

3.2.2. The European System of Financial Supervisors

Schoenmaker and Oosterloo (2008) proposed[43] a creation of the European System of Financial Supervisors (ESFS) by the European Financial Agency (EFA) cooperating with national supervisors. According to them, main advantage of the ESFS is that it will create the European framework, i.e. harmonization of the supervisory requirements[44], thereby level playing field for all market participants. The ESFS will be responsible for a financial stability of all EU countries therefore problem of neglecting of cross-border spill-over effects would be addressed. The ESFS will be responsible for both branches and subsidiaries of banks with cross-border activities. Simultaneously, day to day supervision will be carried out by national supervisors endowed by a local knowledge therefore subsidiarity principle would be applied. This approach is conceptually similar to the creation of the European System of Central Banks (ESCB).[45]

For small to medium banks impact will be limited, since they will be supervised by a national branch of the ESFS. The larger the bank and more cross-border operation it has, the higher the impact of the ESFS would be. Harmonization of a supervisory requirements, principles and institutional background would be beneficial for all cross-border active participants by means of lowering of compliance costs. Large multinational banks would be supervised by the lead supervisor, i.e. a national branch of the ESFS where a bank is founded. This will solve a problem of duplicity of supervisors, since banks will report to a single supervisor, who would have to provide information to all other involved national branches of the ESFS. Host authorities have

[43] Advocated by Lannoo (2008) as well
[44] They advocate harmonization of regulatory framework as well.
[45] The ESFS was originally part of the roadmap that led to the creation of the ESCB in 1998. See Lannoo (2008) for details.

to cooperate with a lead supervisor. If host authorities consider that their interests are neglected, they can ask the EFA to overrule a lead supervisor (Schoenmaker and Oosterloo, 2008).

Assessment according to the criteria: 1. Authors suggest that this approach is more effective then the current setting. In fact, for the supervision of the most of banks, nothing will change. The larger the bank the higher the impact will be. Cooperation will be enhanced since distribution of competences would be more legible therefore this model would be more effective. 2. Problem of duplicity is solved.[46] 3. The EFA as the highest decision-making body would be responsible for a financial stability of all countries hence financial stability should be improved. 4. Harmonization of all reporting and supervisory requirements under one system will allow for the existence of the two-tiered supervisory system without breaching the level playing field for all participants. 5. Proximity of the supervisors would depend heavily on the level of integration of internal procedures in banks.

Following the arguments of Mayes (2006) that there is an insufficient harmonization of the institutional framework in the EU countries, creation of the ESFS aimed at harmonization of supervisory requirements and supporting harmonization of regulatory requirements at the same time is welcome. This approach satisfies demands of Padoa-Schioppa (2004b) to minimize huge compliance costs as well.

This approach is very close to the home country supervision structure, but it incorporates the EFA as the highest decision-making body. However, from the proposal it is not very clear how the medium sized regional banks will be supervised. Banking groups as Erste group are of systemic importance in the CEE countries, but still too small when compared to largest ones. From the proposal it is not clear, what are the principles that have to be implemented for banks as this one. All above mentioned features are heavily dependant on an arbitrary set dividing line to divide banks according to their size. Lannoo (2008) pointed out that threshold of the EU merger control regulation can function as a dividing line between national and regional banks on one hand and multinational banks on the other hand. Hence this proposal can be perceived as incomplete and needs a more detail description since it is not solving cross-border externalities of medium sized regional banks. It is obvious that proposals

[46] Schoenmaker and Oosterloo (2008) do not go much into the details of the supervision for the group of small and medium sized banks. Since modification of home country supervision model is used for group of large banks, one can expect the same principles for this group as well.

in last two years were more oriented towards global crisis solving problems than general proposals for the EU. From the perspective of the NMS12 countries, where usually regional consolidators are active, these proposals are less interesting. Authors, themselves, are very cautious about the implementation, since a unification of frameworks is not achievable easily.

Since limits the resolution of the EFA are too long, one might fear the bankruptcy of a troubled bank, should a supervisor disagree with a leading supervisor and the decision-making procedure would be delayed. Another point to be solved is a fiscal responsibility in the case of the ESFS already mentioned by authors. They suggest that fiscal responsibility should reflect the creation of the ESFS. According to Lannoo (2008) who advocates this approach as well creation of the European Resolution Trust is needed.

3.2.3. The Italian model of supervision

Padoa-Schioppa (2004b) presented a vision of a supervisory structure which will fit to the today's banking market in Europe. He did not call for the implementation of the Italian model of supervision explicitly. He rather pointed out principles, which should be applied for creation of the framework. Those who know Padoa-Schioppa's work and the Italian supervisory model see that it clearly fits to the requirements and principles that Padoa-Schioppa presented.

The Italian model is a typical two-tiered supervisory structure with the central bank - Banca d´Italia as an institution responsible for the banking supervision. Most of the banks in Italy operate within a region or even a single city. In 1998 more than two thirds of banks operating in Italy represented this group (Padoa-Schioppa (2004a). Those banks are supervised by a local branch of the central bank. All other banks that exceeded the regional size are supervised by the headquarters of the central bank, which cooperates with its local branches.

Level playing field for all banks is enabled by the same supervisory requirements for banks despite varying supervisor. In the context of the proposal for the European Union, levelling regulatory and supervisory framework is *conditio sine qua non.* Therefore, the preparatory phase for the implementation of such proposal will be a long process. However, as already mentioned, uneven institutional framework is a

serious obstacle for any change of supervisory framework leading to a creation of the framework with foundation on the European level.

This proposal means a creation of a centralized European supervisory body either within the ECB or independent of the ECB. It would be responsible for banks with cross-border activities, where it would act as a consolidated supervisor which would have full responsibility for supervision and will coordinate the activities of national supervisors. As in the Italian case, banks operating within a single country would be supervised by a national supervisor. Important advantage of this model is that not only few arbitrary set multinational banks would be supervised in different manner, but all banks that would exceed a national importance would be supervised by a centralized body.

Assessment according to the criteria: 1. The impact on banks would be similar as in case of a creation of the ESFS. In fact, for a supervision of most of the banks, nothing will change. The debate is only about banks operating cross-border, where the European supervisor would act as a lead supervisor and would coordinate the activities of national supervisors. This proposal encompasses all banks operating cross-border, not only the largest ones. Cooperation would be enhanced since distribution of competences would be more legible, therefore this model would be more effective. 2. The problem of duplicity would be solved. 3. The authority as the highest decision-making body would be responsible for a financial stability of all countries hence financial stability should be improved. It is important to note that national supervisors will supervise banks with lower importance, while those of systemic risk would be supervised by the European authority. 4. Harmonization of reporting and supervisory requirements under one system would allow the existence of a two-tier supervisory system without breaching the level playing field for all participants. 5. Proximity of the supervisors would be satisfied as well.

Important point to be solved, as in the case of the ESFS, is a fiscal responsibility. Fiscal responsibility should reflect a creation of a centralized body. Fiscal responsibility, shifting of competences and loss of supervisory sovereignty are serious obstacles for the implementation of this proposal.

3.2.4. Originally evaluated models

Models already evaluated in original paper presented by Schoenmaker and Oosterloo (2005) will be discussed only briefly. It is because some of the models are very theoretical and are unlikely to be implemented. Moreover, there is no need to replicate what was already presented by the authors in the original paper and what was accepted by others.[47] The home-host supervisory model is the current model and it was already extensively discussed in chapter two.

The "home on the basis of a national mandate" model means that a home supervisor supervises the group as a whole regardless of a branch/subsidiary operational form with a national mandate. Therefore, a national financial stability, national fiscal needs and other national aspects are taken into account only.

On the other hand, the "home on the basis of the European mandate" assumes that a group is supervised as a whole regardless of a branch/subsidiary operational form with the European mandate. Therefore a financial stability, fiscal needs and all other aspects of all countries involved have to be taken into account. Home supervisor is a lead supervisor in this model.[48]

The "central body on the basis of the European mandate" assumes a centralization of the supervisory powers in hands of a single European institution. It does not mean that national supervisors will cease to exist. It means that a central body will act as a consolidated supervisor, with full responsibility for the coordination of the activities of all subordinated bodies.

The "host on the basis of a national mandate" model means that host supervisors can take over the supervision of both subsidiary and branch, if they consider that activities of a bank are significant in a country and should by supervised by the authority of a host country. It will mean either a suspension of supervision on a consolidated basis or full reliance on host country supervisors. Evaluation of all above mentioned supervisory structures is presented in Table 2.

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[47] *Inter alia* Mayes (2006), who completely adopted evaluation of Schoenmaker and Oosterloo (2005).
[48] Schoenmaker and Oosterloo (2005) were already in this paper before crisis considering the European System of Financial Supervisors as a combination of "home on the basis of European mandate" and "Central body on the basis of European mandate" models as described in their paper.

Table 2: Evaluation of supervisory structures

Supervisory structure	Criteria				
	1. Effectiveness of supervision	2. Efficiency of supervision	3. Financial stability	4. Competitiveness of financial firms	5. Proximity to financial firms
A. Home and Host (current system)	+	+/-	+/-	+/-	+
B. Home on the basis of a national mandate	+	+	-	+	+
C. Home on the basis of a European mandate	+	+	+	+	+
D. Central body on the basis of a European mandate	+	+	+	+	-
E. Host on the basis of a national mandate	+/-	+	-	-	+

Source: Schoenmaker and Oosterloo (2005)

The "home on the basis of a national mandate" is superior to the current system in the efficiency and competitiveness criteria because it eliminates duplicity of supervision for subsidiaries. However, the only shortcoming, the financial stability issue is very important obstacle for the implementation. Neglecting the cross-border spill-over effects is unacceptable and *de facto* disqualifies this proposal. The "home on the basis of a European mandate" is rated as superior to all other models. Authors suggest that it should be a basis for the future ESFS model. However, in their evaluation, there is an assumption of existence of some centralised body thereby already a combination of C and D models from the table instead of genuine C model as was supposed to be evaluated. The "central body on the basis of European mandate model" faces the problem of being too far to small national banks, therefore proximity criterion is not met. Last model "host on the basis of a national mandate" goes against the objectives of a creation of the Single Market. It will mean a reverse of integration and fragmentation of the market, not allowing operation via branches etc.

In spite of suggestion that model C is superior to all other models if executed as the ESFS, Schoenmaker and Oosterloo (2005) warned that both the ELA provisioning and fiscal responsibilities should be shifted to correspond to the changes in supervision.

3.3. Why is the US supervisory model not applicable in the EU?

"Make everything as simple as possible, but not simpler."

Albert Einstein

This subchapter will be devoted to a brief description of the US supervision to explain the differences of both systems and rather to point out important impediments to the application of the system for the EU than to propose the system for the EU.

First of all, we would like to remind that the US is a federation of states while the EU is an economic and political union of sovereign states. There is a huge federal budget in the US which allows for redistribution among states. In the EU, there is a common budget, allowing for redistribution as well, but it presents only a small fraction compared to national budgets. Moreover, any questions related to the redistribution among sovereign states are politically sensitive and consensus is hardly achievable. This involves bail-outs, deposit insurance and lender of last resort issues. All of these are nationally based in the EU.[49] According to many authors this is a strong impediment precluding the EU from a serious integration of its financial supervision, see *inter alia* Boot (2007), Dermine (2005), Godhard and Schoenmaker (2006), Mayes (2006) and Schoenmaker and Oosterloo (2005).

In the US the most important institution with the respect to the banking supervision is the FDIC. Therefore, there is single deposit insurance at place, and it will bear the costs of a bank failure regardless of the state where the bank operated. In the EU deposit insurance is still a national business and it is rather passive institution as already mentioned. It is not responsible for the supervision. Of course, not only the FDIC is responsible for supervision, it shares competences with the Federal Reserve (FED), the Treasury and the Securities and Exchange Commission (SEC) since Gramm-Leach-Bliley Act.[50] Forbearance to act is eliminated by direct incentives to take prompt actions with a view to minimise the costs by the FDIC.

Federal institutions have stronger mandate and tackle banks harder as their European national counterparts. Decision-making procedure is much prompter with a federal mandate as in the case of cooperation of bodies with national mandate.

[49] In the case of the lender of last resort, there is a discussion in chapter 2.4 that in some cases, as global crisis, the ECB might serve as a lender or last resort too.

[50] See Carmassi (2009) for further details.

Supervision in the EU is heavily dependent on cooperation of national supervisors. Regardless of the existence of coordination mechanism as proposed above by creation of the ESFS or other mechanism, reactions will be delayed in comparison with the US reactions.

There are, however, some other characteristics that make supervision more difficult in the EU. As Mayes and Wood (2008) pointed out, there are about 10 banks in the US, which are perceived to be too big to fail. In the EU, there is a couple of banks in each of the member states that are too big to fail, therefore in total there are tens of banks with a too big to fail status in the EU. Therefore even if, there would be a single European supervisor, a single deposit insurance fund and common budget, the US model is still not applicable since, one can not imagine closing of largest bank in one of the Baltic countries despite marginal "EU market" share and marginal importance on the EU level. Mayes (2009b) pointed out that in the US problems of most of troubled banks were solved without taxpayers funding.[51] This is a result of strong mandate of supervisor, robust *ex ante* rules. It allows authorities to solve the problems of troubled banks sooner than they become truly insolvent.

The EU supervision is based on the supervision of local banks, since retail banking is still a local business. Micro-prudential supervision is usually working properly, but due to the fragmentation of supervision on a national level, macro-prudential issues of systemic risk and cross-border contagion are not fully taken into account. Since the mandate of the US supervisors is on federal level, macro-prudential issues and contagious effects are fully taken into account.

Until now, the EU was not able to enforce level regulatory framework in all member states. It is obvious that the decision-making in the EU is too complicated to allow needed changes to be implemented thereby to reach the system similar to that of the US. "National specifics" are usual argument in delaying a harmonisation of "local banking industry". However integration of a wholesale banking is much more advanced than the EU's ability to follow this process.

This is, however, not an impediment to implement parts of the US framework, which are applicable and has proven to be efficient in the US. Mayes and Wood (2008) pointed out that there is no Prompt Corrective Action on the EU level as it is in the US even though such framework is applicable in the EU as well. Mayes (2009a) described

[51] At the time when conference took place, there were 130 banks successfully solved in the US without additional funds.

the Structured Early Intervention and Resolution (SEIR) as a European version of the US Prompt Corrective Action (PCA) originally proposed by Benston and Kaufman in 1988 and adopted three years later in the US. The PCA is based on a verification of capital ratios namely total risk-based capital, tier 1 capital and leverage. Banks are then sorted in categories[52] which subsequently determine their treatment. Provisions are either mandatory or discretionary. Mandatory provisions have significant *ex ante* effect, providing strong incentive to shareholders to recapitalize the bank in advance.[53] For the EU, working under today's Memoranda of Understanding framework resulting in forbearance of supervisors as described in chapter 2.3, a clear rule, which will trigger the action, is welcome.

Implementation of the SEIR in the EU would need a harmonization of the regulations and minor legislative changes. It was already mentioned that a federal mandate of the US institutions enabled harder tackling of banks. It is questionable whether European national supervisors would be assertive enough to start the procedure with a strong European bank operating in few EU countries. If not, *ex ante* effect might be undermined as well.

3.4. Conclusion

"Whosoever desires constant success must change his conduct with the times."
Niccolò Machiavelli

From the discussion above about possible supervisory models the first conclusion is that finding a solution is about balancing trade-off effects. None of the proposed supervisory models is easily achievable and satisfies all the demands imposed on the supervisory model for the EU at the same time. However, there are mentioned important features of such supervisory model and its prerequisites. Even though models themselves are concerning organizational structure and setup of supervision, authors see that changes they propose are only a part of a more fundamental change that is needed. There is a serious need to narrow a regulatory framework of the EU member states, to

[52] PCA has 5 categories, UK has decided to implement system of the SEIR with 3 categories, and originally proposal system had 4 categories.
[53] See annex 3 for details.

create a homogeneous framework or at least to converge to homogeneity gradually. Harmonization of regulatory and supervisory requirements is an important precondition for the integration of supervision within the EU. Harmonization of the regulatory framework is then perceived as necessary condition, while harmonization of supervisory requirements is needed to preclude from discontinuity and sudden change for market participants. Prior to implement sufficient supervisory structure, framework for a banking supervision related spending on the EU level should be solved. Without these steps, profound change of the EU supervisory framework is not possible. These tasks are, however, enough for many years ahead due to the complicated and slow decision-making procedure in the EU.

Mentioned proposals are based on both centralized and decentralized approaches. However, in fact, the outcomes do not differ so much. Centralized approaches do not mean creation of a single central body to replace all national supervisors. It only means that the final responsibility will lie on the shoulders of a central body. From the comparison with the US, it seems that some level of centralization meaning a creation of a strong authority that will be assertive enough to tackle banks much harder and sooner as it was in the EU until most recently is justifiable. Centralized body would be responsible for coordination of (former) national supervisors what would replace failed legally non-binding Memoranda of Understanding. This is, however, difficult to be implemented as well seeing the resistance of authorities to give up sovereignty and politicians giving up national competences. From the perspective of politicians, decentralised approaches are considered to be more feasible in the EU.

Decentralised approach means that ultimate responsibility lies on the shoulders of a lead or consolidating supervisor, who would be formed for each multinational bank. This would mean a creation of many supervisory colleges consisting of conditionally sovereign supervisors who have to cooperate. Conditional sovereignty expresses the fact that a supervisor is ultimately sovereign only if is in a position of a lead supervisor in a college, otherwise sovereignty is limited by a lead supervisor. As the practice of Memoranda of Understanding has shown, cooperation of unconstrained supervisors did not work properly. In this view, country-wide coordination seems to gain importance in this trade-off issue between sovereignty and country-wide cooperation. However, as already mentioned shift of accountability should be followed by the shift of fiscal

means. It does not mean necessarily higher spending. It should rather express a preparedness to act hence enforce market discipline *ex ante*.

Two-tiered models are very similar to the centralized models. Their objectives are the same, to provide adequately strong supervisors for large multinational financial institutions (conglomerates). The way how to achieve it might look very different. However in both cases impact on small banks operating within a single country would be very limited if any. The main difference between centralized and two-tiered models is in a treatment of banking groups operating cross-border, but not large enough to be treated by a centralized body. Regardless of the threshold that would be chosen, continuity in supervision of banks following their growth is preferred, based on the elementary criterion of Schoenmaker and Oosterloo (2008) that *"supervisory structure should [...] adapt to market developments and not the other way around."*

Even though some proposals to enhance the supervisory framework in the EU are applicable quite easily, as for example the Prompt Corrective Action proposed by Mayes (2009a), effect will be much stronger when applied jointly with a profound change of the institutional framework as stated above. Therefore, to achieve integrated supervision on the EU level, many institutional changes are needed. Unfortunately, no instant form of convenient institutional framework exists. Transition from one framework to another one related to essential changes is always a long journey.

4. The EU response to the supervisory failures

"Change is hard because people overestimate the value of what they have and underestimate the value of what they may gain by giving that up."
James Belasco and Ralph Stayer

In previous chapters we have described the current regulatory and supervisory framework in the EU and analysed major shortcomings of the current system. All major problems were summed in chapter 2.3. In chapter 3 we have set basic requirements for a new supervisory model, set the criteria for evaluation of competitive supervisory frameworks, described and analysed various supervisory models and proposals. Further, we have concluded that despite formal and organizational differences among models, basic principles are quite similar.

In this chapter we will describe and analyse the activities of the EU aimed at solving the problems that emerged or better to say became important during the financial crisis. This chapter will be organized as follows. First subchapter contains three parts, first summarizes all plans, discussions and proposals of the early stage. Second part will summarize proposals contained in De Larosière Report (2009). Third part contains concrete steps that were taken. In second subchapter, we will analyse and evaluate these steps.

4.1. What was done so far?

"If Columbus had an advisory committee he would probably still be at the dock."
Arthur Goldberg

4.1.1. First reaction

The EU responded to the supervisory failures adopting the roadmap in October 2007. The roadmap was a set of measures enhancing a regulatory and supervisory framework. However no deep structural changes were incorporated in this action plan. During the next months the Ecofin Council was very active, reacting to the up to date development. In December 2007 the Ecofin Council decided to solve the problems via

the Level 3 Committees i.e. the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR). According to the Ecofin Council, they should enhance the application of their guidelines on a national level, to be more operative, hence qualified majority voting should be introduced (Lannoo, 2008). However the outcome of the Level 3 Committees should be more consultative, non-binding. New framework for these committees was set by the decisions of the Commission.[54]

Padoa-Schioppa (2007) proposed shift from the legally non-binding nature of the decisions. He suggested that decisions of the Level 3 Committees should be legally binding, but the suggestion was not successful. The problem of the Ecofin Council was that there were too many proposals and lack of consensus.[55] The role of the Level 3 Committees was enhanced. However colleges of supervisors were entrusted to carry on the supervision of the EU-wide financial groups. Cooperation of the colleges was set by the Memorandum of Understanding signed by at least 113 supervisory authorities, central banks and finance ministries. This Memorandum of Understanding was legally non-binding as well (Lannoo, 2008). One might conclude from the brief summary of first reactions to the crisis above that parties can agree much easier on non-binding agreements than on binding ones. Despite the crisis, involved parties were not able to respond swiftly and adequately to the problems that occurred what leads to the insufficient solutions on the EU level. In fact, almost no enhancement was achieved in this phase. It shows that decision-making procedure in the EU is an obstacle to swift reactions.

[54] Commission Decision C(2009)176 establishing the Committee of European Securities Regulators; Commission Decision C(2009)177 establishing the Committee of European Banking Supervisors; Commission Decision C(2009)178 establishing the Committee of European Insurance and Occupational Pensions Supervisors

[55] To name few some of them, establishment of supervisory colleges, strengthening of the Level 3 Committees and their turn into the EU Agencies and creation of the ESFS similarly to the creation of the ESCB were proposed.

4.1.2. De Larosière Report

In February 2009, first integrated strategy was elaborated and presented as the De Larosière Report (2009). This report will be described in detail seeing the impact of the report on further development. Main points of the report are:

1. It recommended transformation of above mentioned Level 3 Committees (CEBS, CEIOPS and CESR) into the European Authorities: the European Banking Authority (EBA), the European Insurance Authority (EIA) and the European Securities Authority (ESA). Decisions of the Authorities should be legally binding contrary to the decisions of the Level 3 Committees and contrary to the Ecofin Council's proposal. These Authorities should have broad competences, *inter alia* setting supervisory standards, mediation between advisors, and oversight of supervisory colleges.
2. There is need for a harmonization of national regulations with the aim to achieve more homogeneous regulatory framework within the EU. Different perception of the core capital as was mentioned in chapter 1.1 should be solved preferably. However, homogeneity of the framework is not advocated, it is still based on the minimal requirements principle, i.e. it means that minimal requirements should be harmonized.
3. The report addressed the problems of a cooperation of national supervisors and proposes binding mediation provided by the Authorities in the case of disputes and replacement of the legally non-binding Memoranda of Understanding by legally binding ones.
4. The ECB should play more important role in a banking supervision, since macro-prudential issues as a financial stability are connected with monetary stability issues which are domain of the ECB. In fact, during the most recent financial crisis, the ECB played very important role by providing liquidity to the market. As report mentioned, early warning of the ECB about potential vulnerabilities and macro-stress testing would have been beneficial during the recent financial crisis and the ECB and its European Systemic Risk Council (ESRC) is most suitable for detection of macro-prudential risks and

vulnerabilities.[56] The report concludes that the ESRC should cooperate with the Authorities transformed from the Level 3 Committees based on the binding agreement.

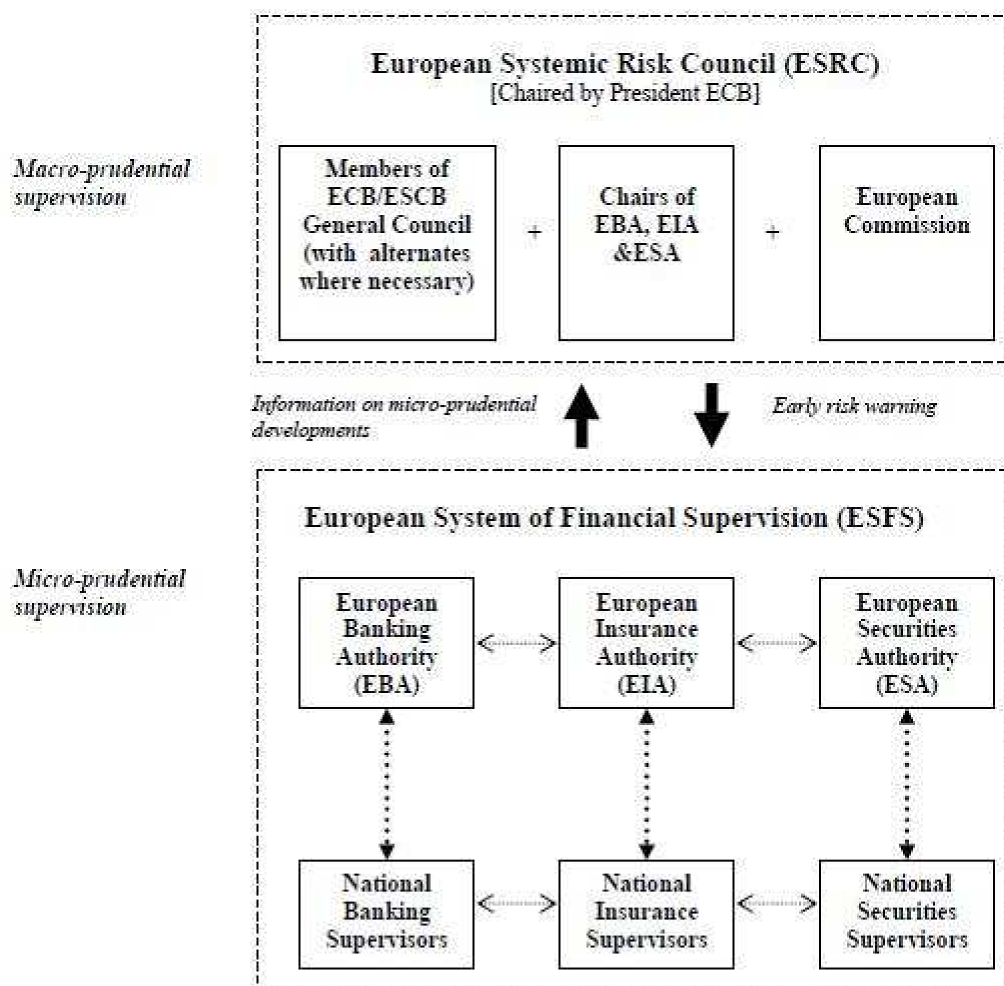
5. The report proposed the creation of the European System of Financial Supervisors (ESFS). Movement towards the ESFS should solve the shortcomings of current system (see chapter 2). Characteristics of the ESFS proposed in the report is very close to the one described in the chapter 3.2.2. Important feature of the ESFS is that it applies the principles of the Treaty, i.e. proportionality and subsidiarity. The day to day supervision should be decentralised issue carried out by national representatives. Superior supervisory framework should be achieved by the harmonisation of rules and requirements, enhancement of cooperation among national supervisors, who will cooperate by means of supervisory colleges.[57] Enhancement of the information disclosure by national supervisors and close cooperation with the Authorities which are about to be created (EBA, EIA and ESA) and with the ESRB is expected. The oversight and coordination of the colleges should be carried out be the Authorities transformed from the Level 3 Committees.

In overall, supervisory framework for the EU is depicted in Chart 6.

[56] The ECB is responsible for the monetary stability of the Eurozone countries only, therefore all above mentioned points are limited to this extend. Therefore extension of the ESRC to incorporate the EU member states outside the Eurozone is needed to amplify the effects.

[57] Supervisory college should be created for all cross-border banks according to the proposal

Chart 6: Supervisory framework proposed by De Larosière Report



Source: De Larosière Report (2009)

4.1.3. Legislative changes

On May 27, 2009 the Commission released that the recommendations of the De Larosière Report (2009) will be largely accepted and soon transposed into legislative proposals. The European Council in June 18-19, 2009 supported the Commission's attitude thereby opened the way to the changes in a legal framework. On September 2009, several proposals were disclosed:

- Proposal for a regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing European Systemic Risk Board (ESRB) – 2009/0140 COM

- Proposal for a council decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board – 2009/0141 COM
- Proposal for a regulation of the European Parliament and of the Council establishing European Banking Authority (EBA) – 2009/0142 COM
- Proposal for a regulation of the European Parliament and of the Council establishing European Insurance and Occupational Pensions Authority (EIOPA) – 2009/0143 COM
- Proposal for a regulation of the European Parliament and of the Council establishing European Securities and Markets Authority (ESMA) – 2009/0144 COM

On October 2010, proposals were followed by amending proposal:

- Proposal for a directive of the European Parliament and of the Council amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the Powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority

To sum up all above mentioned regulations and directive, the purpose of following regulations is to establish the European Authorities according to the De Larosière Report (2009). The directive amending various directives treating financial services is aimed at specifying their functions and empowering them to act. The European Commission (2009b) declared clearly the tasks for the ESFS, *inter alia* to ensure a single set of harmonized rules, to bring about consistent application of the EU rules,[58] to ensure common supervisory culture and consistent supervisory practices.[59] Important feature of the ESFS is that it introduces a simple majority voting for individual cases and qualified majority voting for binding technical standards, *ergo* no unanimity voting.

However, implementation will not be an easy task. Soon after the De Larosière Report (2009) was published, first critiques emerged. Let us mention probably the first and most comprehensive one published by the CNB (2009). The CNB partly accepts the findings of the Report. However, in fields where the sovereignty of the CNB would be

[58] This should eliminate usual differences in transposition of directives into national legislature.
[59] For full list of responsibilities and powers see European Commission (2009b)

weakened, clear resistance is present. The CNB considers today's framework for cooperation, harmonization and convergence to be sufficient. Therefore, the CNB rejected in this document and also during the negotiation phase the most important proposals leading to the creation of the ESFS. It pointed out that lender of last resort issues should be solved first and put stress on the accountability issues. Therefore, since October 2009, no progress was achieved.

4.2. Analysis of the EU reaction

"Advice is judged by results, not by intensions"
Marcus Tullius Cicero

First of all, it is important to note that one can judge the work of the European Commission as soon as the legislature will be in force. Nowadays, only proposals for regulations and directives exist. However, it is reasonable to evaluate potential impacts of proposals and to detect milestones of the proposed changes.

Proposed development is based on the harmonization of the rules and creation of level playing field, or correcting existing inequalities at least. This need was pointed out by various papers devoted to this topic (see chapter 2) thereby such activities are welcome and generally accepted. The only question left in this respect is, whether the authorities will be able to cope with these tasks and converge to homogeneity. Once simple or qualified majority applies, no problems are expected and consistent application of the EU rules would be comfortably achievable. However, those who oppose changes that would lead to the voting system without unanimity today are those who fear that they will be affected in future and thereby will be forced to adhere to the EU rules. Therefore one can conclude that this point is reachable only when the voting system will be approved.

Working under the legally non-binding Memoranda of Understanding has proven to be inadequate and problematic. Agenda being supported by the EU based on the De Larosière Report (2009) is based on the colleges of supervisors. The Report is based on the assumption that the failure is a result of the vague or insufficient specification of a burden sharing i.e. relies on the economic impact on member states and allocation of the supervisory powers only. Adding other specifications to the burden

sharing will not solve the most important shortcoming of the Memoranda of Understanding, their legally non-binding character. This problem would be solved be the binding resolution of the ESFS in the case of disagreement among supervisors in college.

Speed of a reaction might be another problem of the ESFS. The European Commission (2009c) states that *"…ESA can assist in finding a resolution within a time limit set by the ESA which takes into account any relevant time limits on the sectoral legislation, and the urgency and complexity of disagreement."* This specification is very vague and in case of a crisis a resolution might come too late.[60] Problems as pointed out in box 2 can therefore occur again. With the respect to the ESA membership it is obvious that national mandate of members might lead to disputes in the ESA and reactions will not be swift. Or as Mayes and Wood (2008) stated: *"Countries would no doubt prefer others to bear a larger proportion of the loss but small countries cannot possibly take on the support of the entire banking group just to maintain systemic functions in their own jurisdiction; and all countries, regardless of size, might be reluctant to support an institution primarily important elsewhere."*

Should a bank be in a distress and emergency actions should be taken swiftly, subsidiaries can be, at least to some extent, treated by respective supervisor despite a lack of consensus among supervisors. However, as Mayes (2009a) pointed out, this is not true in case of the branches and the De Larosière Report (2009) has no solution how to solve the problems promptly. Chapter 3 concluded that promptness of actions and strong *ex ante* enforcement of market discipline can be reached by means of providing supervisors with a strong mandate with real fiscal means in case of need.

What seems to be a problem for the implementation of proposals based on the De Larosière Report (2009) is a resistance of the supervisors seeing a loss of sovereignty as stated above and depicted on the attitude of the CNB (2009). However, without creation of a mechanism for efficient cooperation of national supervisors instead of the Memoranda of Understanding that proven to be improper, no significant improvement can be achieved. By opposing those points, supervisors as the CNB (2009) agree only on the cosmetic changes which are important but still not sufficient by one step missing. Such problems are expected due to different levels of foreign banks` penetration as discussed in first chapter.

[60] This argument is supported by Mayes (2009) as well.

5. Conclusion

"It is not necessary to change. Survival is not mandatory."
William Edwards Deming

Creation of the Single Market belonged to the priorities of the EU. The success of the integration process, however, revealed weak preparation of the integration in terms of the creation of a suitable institutional framework for integrated banking in the EU. Shortcomings of the framework were veiled well by the years of prosperity until the financial crisis of 2008-2009 revealed them. Many problems were already described by the economists before the crisis, but policymakers neglected them. It is easy to blame the policymakers for not solving the drawbacks, but one should keep in mind that any institutional change within the EU is difficult because of the decision-making procedure. The topics of banking supervision were perceived as the most sensitive and were blocked for decades. However, progress in the field of banking integration separated from progress in regulation and supervision clearly led to the asymmetric position of parties. Asymmetry between banks and supervisors is not necessarily advantageous for one of the parties. Large multinational banks facing the requirements of fragmented supervisors face huge compliance cost, and they prefer having one strong supervisor instead.

New problems, such as cross-border contagion, emerged. Due to high interdependence of banks, financial stability became a more pan-European topic than the national one. Cooperation of fragmented national supervisors was based on legally non-binding Memoranda of Understanding. Illusion that they work vanished during the financial crisis when their improperness turned out. The opportunistic behaviour of supervisors outweighed the loss of their reputation. As a result, a couple of banks were close to bankruptcy due to forbearance of supervisors and their dead man game. Besides that, conditions for participants are not even due to differing supervisors with respect to a branch/subsidiary structure and thereby following differing requirements of supervisors. The current supervisory framework is a result of *ad hoc* adjustments reflecting needs and difficulties in reaching the needed consensus in terms of the EU decision-making procedure. To use the words of Allan Sherman, "each person puts in a pretty colour and it comes out grey."

A significant lack behind the integration of the banking sector signalizes that some minor *ad hoc* solutions will not be enough. It is important to start with the integration of supervision as a continuous process not only to reflect the crisis, but to look forward, as well. Therefore, it is necessary to start with a serious, profound change of architecture of the EU. It will only be a partial solution to change the framework without addressing the problems of the lender of last resort, deposit insurance and related spending issues at the EU level. Keeping in mind the problematic decision-making procedure in the EU, these questions are not likely to be addressed within the current decision-making framework. Therefore, we come to the conclusion that the integration of supervision is dependent on a very broad set of requirements and no instant and sufficient solution is possible. The integration of supervision looks like a marathon rather than a sprint.

These findings do not mean that no change is possible within the current decision-making procedure rules or without solving all the problems at once. Of course, solving the problems *per partes* is not ideal and will probably lead to the prolonging of the period when changes will be implemented. However, it is probably the only viable way. There is a consensus that the levelling of the regulatory framework is a very important step and is virtually applicable without any decision at the European level. To level the regulatory framework, only a strict transposition of directives not allowing for exceptions is needed. This step is not important with regard to the change in the supervisory framework *per se*. It will minimise the compliance costs of credit institutions operating cross-border, therefore it will enhance the competition within the Single Market. There is also a consensus that the current supervision based on the legally non-binding Memoranda of Understanding in the framework founded on home country supervision is not satisfactory.

There is no clear consensus about the future framework for supervision either among academicians or representatives of the EU countries. In case of academicians, a lack of consensus is usual. Differences among the proposals are reflecting differences in supervision at the national level, as the status of the supervisor – whether the supervisor should be a part of the central bank or rather independent of the central bank. Another aspect is the level of centralization, whether to create a single supervisor to coordinate national supervisors or to build on the system of supervisors. Nevertheless, principles upon which the proposals are founded are basically the same, i.e. to move the supervision to the European level, setting the lead supervisor with the ultimate

responsibility for cross-border banking groups. Therefore, the degree of difference is much lower than one can expect at first sight.

A shift from the national level supervision to the European level one is expected to enhance a mandate of supervisors and to narrow the asymmetry between supervisors and banking groups. Moreover, fiscal responsibilities should be addressed at the same time, otherwise the position of supervisors is weakened and they become powerless. Without the distribution of fiscal responsibilities and means, supervisors are not able to threat banks aggressively enough and *ex ante* effects stemming from the ability to enforce the market discipline are weakened. It is obvious from the comparison of the EU and the US supervision that the US supervisors have a stronger mandate. Therefore they are more prompt in solving problematic banks. Prompt treatment and strict enforcement of *ex ante* rules have disciplining effects on the market and a positive effect on the public spending, as well. Therefore total bill for the supervision is not expected to be higher.

A lack of consensus among the representatives of the EU countries is quite natural. Countries are in different positions with regard to the proposals. For those where banks are predominantly foreign, as for example in the CEE countries, the representatives fear a shift of the ultimate responsibility and competences to a supranational institution or to a leading supervisor. The later is probably politically more sensitive, due to a shift of competences to a previously national supervisor of another EU country. However, a shift of powers without a shift of fiscal responsibilities and means is hardly acceptable for such countries. A profound change can not be reached without addressing the question: “Who will pay the bill?”

Annexes

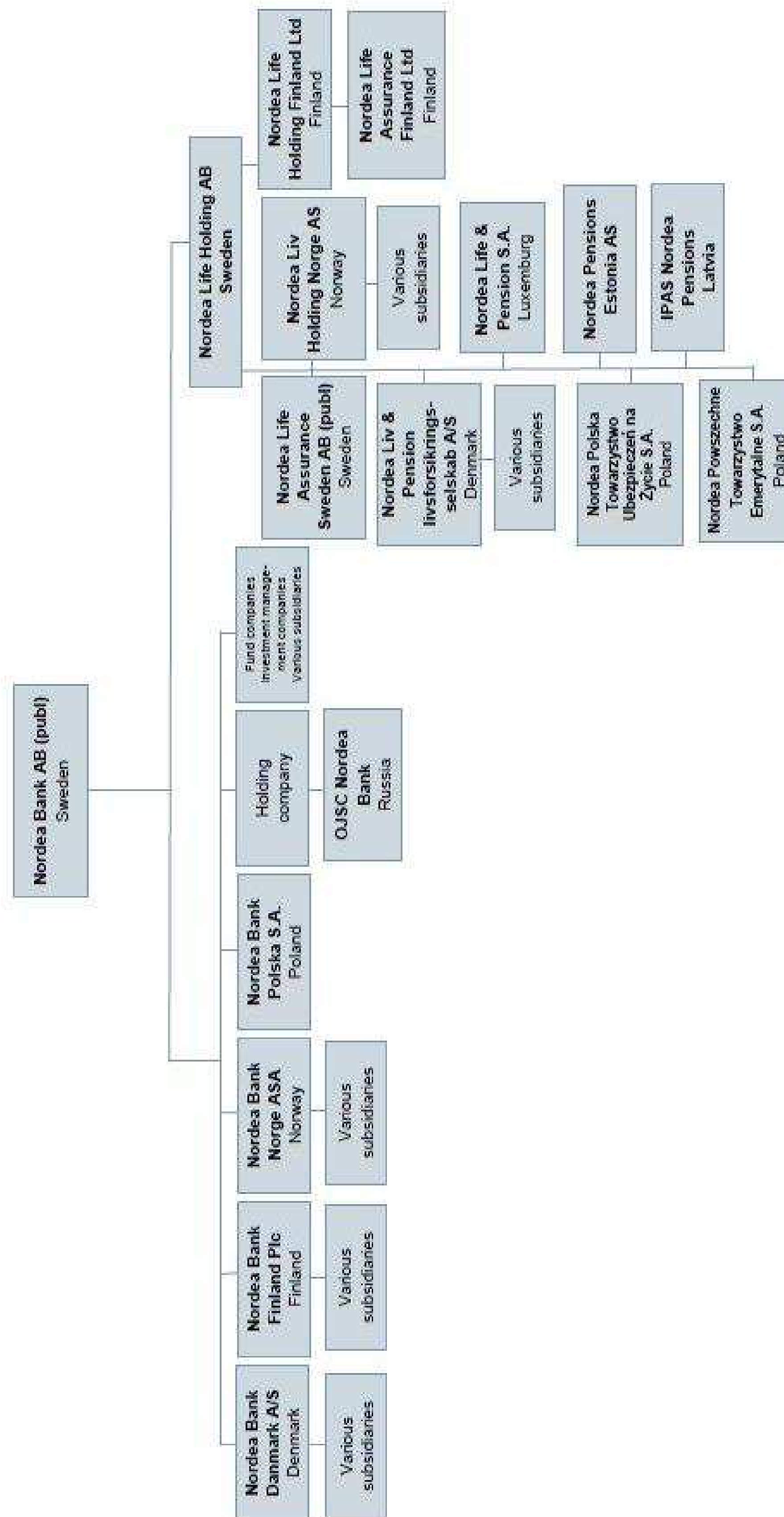
Annex 1: Herfindahl index for credit institution's and share of the 5 largest credit institutions in total assets

(index ranging from 0 to 10,000 and share of the 5 largest CIs in percent)

	Herfindahl index for CIs					Share of the 5 largest CIs in total assets				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Belgium	2,063	2,102	2,112	2,041	2,079	83.5	84.3	85.3	84.4	83.4
Bulgaria	n.a.	721	698	707	833	n.a.	52.3	50.8	50.3	56.7
Czech Republic	1,187	1,103	1,155	1,104	1,100	65.8	64.0	65.5	64.1	65.7
Denmark	1,114	1,146	1,115	1,071	1,120	66.6	67.0	66.3	64.7	64.2
Germany	173	178	174	178	183	21.6	22.1	21.6	22.0	22.0
Estonia	3,943	3,887	4,039	3,593	3,410	99.2	98.6	98.1	97.1	95.7
Ireland	500	500	600	600	600	44.4	43.9	45.7	44.8	46.1
Greece	1,130	1,070	1,096	1,101	1,096	66.9	65.0	65.6	66.3	67.7
Spain	506	482	487	442	459	43.1	41.9	42.0	40.4	41.0
France	597	623	758	726	679	46.7	49.2	51.9	52.3	51.8
Italy	240	230	230	220	330	27.5	26.4	26.8	26.2	33.1
Cyprus	946	940	1,029	1,056	1,082	57.2	57.3	59.8	63.9	64.8
Latvia	1,054	1,021	1,176	1,271	1,158	63.1	62.4	67.3	69.2	67.2
Lithuania	2,071	1,854	1,838	1,913	1,827	81.0	78.9	80.6	82.5	80.9
Luxembourg	315	304	312	294	276	31.8	29.7	30.7	29.1	27.9
Hungary	783	798	795	823	839	52.1	52.7	53.2	53.5	54.1
Malta	1,580	1,452	1,330	1,185	1,174	77.7	78.5	75.3	71.4	70.1
Netherlands	1,744	1,726	1,796	1,822	1,928	84.2	84.0	84.5	85.1	86.3
Austria	557	552	560	534	527	44.2	43.8	45.0	43.8	42.8
Poland	754	692	650	599	640	52.0	50.0	48.5	46.1	46.6
Portugal	1,043	1,093	1,154	1,134	1,097	62.7	66.5	68.8	67.9	67.8
Romania	1,251	1,111	1,115	1,165	1,041	55.2	59.5	59.4	60.1	56.3
Slovenia	1,496	1,425	1,369	1,300	1,282	66.4	64.6	63.0	62.0	59.5
Slovakia	1,191	1,154	1,076	1,131	1,082	67.5	66.5	67.7	66.9	68.2
Finland	2,420	2,680	2,730	2,560	2,540	81.2	82.7	82.9	82.3	81.2
Sweden	760	854	845	856	934	53.8	54.4	57.3	57.8	61.0
United Kingdom	347	376	399	394	449	32.8	34.5	36.3	35.9	40.7
MU13	579	599	642	630	654	40.5	41.6	42.6	42.8	44.1
unweighted avg.	983	997	1,029	996	1,006	54.2	54.2	54.9	54.4	54.7
EU27	545	567	600	588	628	39.7	40.9	42.1	42.1	44.4
unweighted avg.	1,145	1,114	1,135	1,104	1,102	58.8	58.5	59.3	58.9	59.4

Source: ECB (2008)

Annex 2: Legal structure of Nordea Group



Source: Nordea Group (2009)

Annex 3: The US Framework for Prompt Corrective Action

Category	Mandatory provisions	Discretionary provisions	Capital ratios: Risk-based capital Total	Capital ratios: Risk-based capital Tier 1	Capital ratios: Leverage Ratio
Well capitalized	No capital distribution or payment of management fees that would cause the bank to become undercapitalized		>10 %	>6%	>5%
Adequately capitalized	1. Same as well capitalized		>8%	>4%	>4%
Undercapitalized	1. Capital distributions and management fees suspended 2. Capital restoration plan 3. Asset growth restricted 4. Prior approval for branching, acquisitions, and new lines of business 5. No brokered deposits	1. Require recapitalization by issuing capital or selling to another firm 2. Restricting transactions with affiliates 3. Restricting rates on new deposits 4. Restricting asset growth 5. Restricting activities 6. Improving management by replacing directors or managers 7. Prohibit deposits from correspondent banks 8. Requiring prior approval for capital distribution by bank holding company 9. Requiring divestiture	<8%	<4%	4%
Significantly undercapitalized	1. Same as undercapitalized 2. At least one of the 9 discretionary provisions under undercapitalized. Presumption in favour of (1) (required capital issuance only), (2), and (3) 3. Senior officer compensation restricted		<6%	<3%	<3%
Critically undercapitalized	1. Any action authorized for significantly undercapitalized banks 2. Payments on subordinated debt prohibited* 3. Conservatorship or receivership within 90 days*				<2%**

* Not required if certain conditions are met.
** Tangible equity only.
Note, this is a general summary of PCA only. Other parts of the US code may also impose limits based on bank's capital category.

Source: Mayes (2009a)

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Projekt diplomové práce

Termín ukončení: **letní semestr 2009/2010**
Autor diplomové práce: **Ivan Trpčevski**
Vedoucí diplomové práce: **Doc. Ing. Pavel Mertlík, CSc.**

Téma: Supervision of the integrated European Banking Market

Cíl práce:

Thesis is devoted to the supervisory issues in the European banking. The aim of the thesis is to point out the problems of the regulatory and supervisory framework and potential risks for financial stability in European countries. Thesis describes and analyses other proposed regulatory and supervisory frameworks. The thesis is not specialized in the problems that occurred most recently, but it analyses current development activated by the crisis.

V práci bude hledána odpověď na následující otázky:

- How does the European banking regulation and supervision work?
- What are the possible risks of this framework?
- Are there possible solutions?
- What are the problems of proposed solutions?
- Is current development in compliance with theoretical approaches?

Metódy:

The topic of the thesis is institutional; therefore methods chosen for this thesis are usual for institutional economy. It is based on the comparison, critique and synthesis of broad literature devoted to European institutions and banking supervision.

Osnova:

1. European banking integration and market structure
2. Regulatory and supervisory issues
3. Problems of current framework
4. Proposed alternative frameworks and their analysis
5. Current development and its analysis
6. Conclusion

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