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Sander Oosterloo
and Dirk Schoenmaker

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Central Banking Publications Ltd
6 Langley Street, London WC2H 9JA, UK
Tel: +44 20 7836 3607, Fax: +44 20 7836 3608
E-mail: info@centralbanking.co.uk
Website: <http://www.centralbanking.co.uk>

A lead supervisor model for Europe

Europe's national supervisors need pan-Europe mandates to supervise their largest banks argue Sander Oosterloo and Dirk Schoenmaker.

Over the last three decades, there has been a clear trend towards globalised finance. Large financial groups are run on a global basis spreading their business – with almost no exception – over the three main regions of the developed world (the Americas, Europe and Asia). In response, regulations are also increasingly based on a global (such as the Basel committee, International Organization of Securities Commissions, International Association of Insurance Supervisors) or regional footing to ensure their effectiveness as well as an international level playing field. However, supervisory authorities, which enforce these regulations, are still nationally rooted with some elements of international or regional coordination. The national base of supervisors is related to political sovereignty

and, more practically, to the issue of jurisdiction. One needs a jurisdiction for enforcement of regulations, liquidation and winding-up procedures and taxation.

Cross-border burdens

The cross-border implementation of the new Basel accord illustrates the challenges of cross-border cooperation for national supervisors. Banks often run their internal risk management models on an integrated/centralised basis and therefore rules drawn up in Basel have always placed strong emphasis on the consolidated supervisor in the home country. Nevertheless, Basel II also envisages a role for supervisors in the host country for the approval of banks' internal models, in particular where banks operate in subsidiary form. This can lead to duplication and, in the case of uncoordinated approval, diverging requirements for banks. There is thus a trade-off between ensuring effective supervision based on home-host cooperation and minimising the burden for banks.

The focus of this article is on cross-border issues in the EU. As a European jurisdiction is (or can be made) available, policymakers have the choice to organise financial supervision on a national or a European basis. The key issue is that national supervisors are not inclined to take into account spillover effects beyond their borders created by the

(potential) failure of financial groups that operate on a EU-wide basis. There is evidence that the intensity of cross-border externalities is increasing in the EU (see box on page 38).

This article is organised as follows. In the following section we examine how financial institutions organise themselves. The country-based model is rapidly fading and firms run their activities management on an integrated and centralised basis. There is a growing consensus that the lead supervisor model is the appropriate answer to this market trend. We next discuss several models for organising lead supervision which have emerged, including our own intermediate model. In the final section, we discuss the policy implications.

Beyond national borders

The organisational structure of international financial firms is moving from the traditional country-based model to a model based on business lines. The growing integration and centralisation of management functions, such as risk management, internal controls, treasury operations (including liquidity management and funding), compliance and auditing greatly affect the scope for control of supervisory authorities. One of the most notable advances in risk management is the growing emphasis on developing a firm-wide assessment of risk.

These integrated approaches to risk management aim to ensure a comprehensive and systematic approach to risk-related decisions throughout the financial firm. Although costly to realise, Flannery (1999) argues that once firms have a centralised unit for risk management in place, they should expect to reap economies of scale in risk management. Moreover, the potential capital reductions that can be achieved by applying the advanced approaches of the new Basel II framework could encourage banking groups to organise their risk management more centrally. Nevertheless, these centralised systems still rely on local branches and subsidiaries for local market data.

Hub and spoke set-ups

Kuritzkes, Schuermann and Weiner (2003) provide evidence that internationally active financial conglomerates are putting in place centralised units for risk and capital management. The dominant approach is to adopt a so-called “hub and spoke” organisational model. The spokes being responsible for risk management within business lines, while the hub provides centralised oversight of risk and capital at the group level. Activities at the spoke include the credit function within a bank, or the actuarial function within an insurance subsidiary or group, each which serves as the front-line managers for most decision-making

as regards trading. Moreover, aggregation across risk factors within a business line also typically takes place in the spokes, often in a finance unit that is responsible for funding and business reporting for the subsidiary. While the hub is dependent on risk reporting from the spokes, in many cases it is also responsible for overseeing the development of a methodology for an integrated economic capital framework that is then implemented within the spokes. The specific roles of the hub vary, but tend to include assuming responsibility for group-level risk reporting; participating in decisions about the group's capital structure, funding practices, and target debt rating; liaising with regulators and rating agencies; advising on major risk transfer

transactions, such as collateralised loan obligations and securitisations; and in some institutions, actively managing the balance sheet.

The move to the centre

In sum, there is clear trend to centralise key management functions that previously belonged with the separate entities of a financial group. Centralisation implies that strategic decision-making is transferred from the functional or sectoral entities of the group to the level of the group as a whole (that is, the holding level). The centralisation of activities (such as asset management) and key



Sander Oosterloo is a policy advisor at the financial markets policy directorate at the Ministry of Finance in the Netherlands working on issues related to banking regulation (including Basel II), financial crisis management and systemic stability. He has written on institutional frameworks for financial stability (focusing on the role of central banks), accountability of financial stability supervisors and EU supervision.



Dirk Schoenmaker is professor of finance, banking and insurance at the Free University Amsterdam and deputy director for financial markets policy at the Ministry of Finance in the Netherlands. Before joining the ministry in 1998, he served as a senior economist at the banking supervisory policy division of the Bank of England. He was a research fellow at the London School of Economics and a visiting scholar at the capital markets and financial studies division of the IMF.

management functions results from the drive of financial groups to reap the benefits from synergies. The prospect of cooperation between different entities of a financial group is an important part of the rationale for the group. During this process, the difference between the legal structure and the operational structure of the group will increase. In consequence, it becomes harder to attribute activities to the legal entities on which the division of supervisory responsibilities is based. A large difference between the legal structure and organisational structure will complicate the execution of supervision, since supervision is based on statutory power to supervise legal entities and this may not correspond to where activities actually take place. This tension between operationally integrated financial groups looking for synergies and legally constrained supervisors looking for an effective lever on key decision-makers in these financial groups poses a challenge for policy.

The main challenges for the supervisory framework are twofold¹. First, how should integrated financial groups be supervised on a day to day basis? Second, how should the cross-border externalities arising from the failure of financial groups that operate on an EU-wide basis be incorporated? (see box on next page).

Preserve current system?

At a conceptual level, the main policy options for the structure of financial supervision are summarised in Table 1. The current system of prudential supervision in the EU (option a) is based on the principle of home-country control. A financial institution is authorised and supervised in its home country and can expand throughout the EU (by offering cross-border services to other EU countries or establishing branches in these countries) without additional supervision. The home supervisor also acts as the consolidated supervisor because it is able to make a group-wide assessment of the risk profile and the required capital adequacy of a financial institution. However, financial institutions also operate through subsidiaries in other countries. These subsidiaries are separately licensed and supervised by authorities in the host country. Furthermore, the host country is responsible for the stability of its financial system. The home and host authorities have to cooperate for financial supervision and stability.

Home supervisor leads

The first alternative (option b) is to give the home supervisor full responsibility for the

¹ Given the importance of financial conglomerates in the EU, we assume that national supervisors operate on a cross-sector basis. See Kremers, Schoemaker and Wierts (2003) on the different models of cross-sector financial supervision.

Cross-border externalities within the EU

Ongoing financial integration fostered by the advance to economic and monetary union and the nearly full completion of the financial services action plan has given rise to increasing cross-border penetration of interbank markets and payment systems, which are important channels for cross-border contagion. Pan-European and regional banks are emerging with a sizable cross-border presence. The level of cross-border business of banking groups is an appropriate measure for the cross-border impact of the (potential) failure of these groups (“cross-border externalities”). Schoenmaker and Oosterloo (2004) have collected a new dataset on cross-border penetration (as a proxy for cross-border externalities) of large banking groups, based on the “transnationality index” calculated as an unweighted average of (i) foreign assets to total assets; (ii) foreign income to total income; and (iii) foreign employment to total employment. The definition of a significant cross-border presence within the EU is twofold. First, a bank that conducts more than 50% of its business abroad (outside its home market). Second, a bank that conducts more than 25% of its business in the rest of Europe. It is found that cross-border penetration within the EU is increasing. Of the top 30 large EU banking groups in 2001, seven banks were considered to be “European” banks that have the potential to pose significant cross-border externalities. This number increased to ten in 2003.

EU-wide operations, both branches and subsidiaries. According to the European financial services roundtable (EFR, 2004) a clearly defined lead supervisor for prudential supervision of cross-border financial institutions would be an important step towards a more coherent and efficient supervisory framework in the EU. The EFR argues that the lead supervisor should in particular be the single point of contact for all reporting schemes, should validate and authorise internal models, approve capital and liquidity allocation, and cross-border set-up of specific functions, and decide about on-site inspections. The EFR agrees that host countries should be involved in the supervisory process, as local supervisors generally have a better understanding of local market conditions. The EFR suggests forming colleges of supervisors (one for each specific group) that advise the lead supervisor and discuss proposals from the local supervisors involved but would not have the power to delay decisions of the lead supervisor. As the role and the powers of the host supervisor in these colleges are advisory, the actual involvement of host authorities in supervision can be limited in practice. Moving to financial stability, the national mandate confines the responsibility of the lead supervisor to the stability in the home country. Home and host countries will have to cooperate for stability purposes.

Table 1. Structure of financial supervision: policy options.

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: Current system (home and host)	+	+/-	+/-	+/-	+
b: Home supervisor leads (on the basis of a national mandate. EFR model)	+	+	-	+	+
c: Home supervisor leads (on the basis of a European mandate, Schoenmaker-Oosterloo model)	+	+	+	+	+
d. Pan-European supervisor (on basis of a European mandate, Breuer model)	+	+	+	+	-

Home supervisor: Europe-wide mandate

The lead supervisor is an appropriate answer to the growing integration and centralisation of large financial groups. But the concept of lead supervisor is not univocal and can be designed in different ways. The second alternative (option c) is advanced by Schoenmaker and Oosterloo (2004). Again the lead supervisor has full responsibility for EU-wide operations in both branches and subsidiaries. Differently from the EFR model, however, the lead supervisor in the Schoenmaker–Oosterloo model has a European mandate to ensure that the interests of all depositors/countries are taken into account. In some form of European system of financial supervisors, national

supervisors could work together with a decision-making body or agency at the centre. Within the system, the supervisor in the country where the bank is headquartered can then act as consolidated or lead supervisor. Accordingly, for financial stability purposes, the home-country authorities (supervisor and central bank) within the European system of financial supervisors and the European System of Central Banks (ESCB) can act within their respective systems.

Pan-European supervisor

The third alternative (option d) is to give the central body of a European system of

financial supervisors full responsibility for the EU-wide operations in both branches and subsidiaries of pan-European banks. Similarly to the Schoenmaker-Oosterloo model, the central body has a European mandate to ensure that the interests of all depositors/countries are taken into account. However, supervision is mainly conducted by the central body, which can work together with national supervisors. Breuer (2000) has advocated the approach of supervision of truly European banks by a central body. The central body in the Breuer model acts as the consolidated or lead supervisor. The logical equivalent would be that the ECB is the focal point for financial stability within the ESCB. In a crisis, the central bodies of a European system of financial supervisors and the ESCB take the lead within their respective systems.

Summing up, the first two models (the current and the EFR models) assume a national mandate with or without some form of cooperation. National supervisors keep their sovereignty. The latter two models (the Schoenmaker–Oosterloo and Breuer models) assume a European mandate. That is a European jurisdiction where supervisors work on a supranational basis.

Scoring the systems

Horizontally, the Figure 1 provides the criteria for judging the different policy options:

- Effectiveness of supervision: supervision of all parts of a financial group and consolidated supervision of the group as a whole;
- Efficiency of supervision: no duplication or overlap of supervision;
- Financial stability: cross-border externalities from a failure of a financial institution are incorporated;
- Competitiveness of financial institutions: financial institutions can operate cross-border without additional burden (eg, notification, regulatory reporting) and are allowed to realise synergies from centralised or integrated operations (eg, risk management, asset management, back-office operations); and
- Proximity to financial institutions: supervisor is close to the (main) operations of financial firms.

The different policy options are scored against the criteria in table 1. We consider the current system (option a) to be adequate, but not optimal. Supervision is effective. Home and host authorities work together for financial stability. However, coordination failure is possible during a crisis, as resolving cross-border externalities relies on voluntary

cooperation. Competitiveness is also half-way: cross-border expansion through branches can be done without extra supervision (only some minor notification procedures) but subsidiaries in the host country experience duplication in supervision from the supervisor in the host country and the consolidated supervisor in the home country.

In comparison with the current system, both the efficiency of supervision and the competitiveness of the financial sector are enhanced under the EFR model.

Nevertheless, the EFR model does poorly with respect to financial stability, as the national mandate does not induce the lead supervisor to incorporate the cross-border externalities from a failure of a financial institution in its decision-making.

The Schoenmaker–Oosterloo model does well on all five criteria; by taking the mandate to the European level, cross-border externalities are taken into account and duplication in supervision is avoided. As argued above, this European mandate can be created through some form of European system of financial supervisors, created by the national supervisors in tandem with a centralised body. Key supervisory decisions as well as the design of policy are done at the centre (in the same way as the ESCB takes decisions on monetary policy). In this way, host country authorities are fully involved and the interests of their depositors are fully taken into account. Day-to-day supervision is conducted by the home country close to the financial firms.

The Breuer model does well on the first four criteria. It also operates within a European system of financial supervisors. But it could be placed too far away from the (main) operations of financial firms to execute its supervisory responsibilities properly, as the focal point for day-to-day supervision will be at the central body. As put by Breuer (2000, p.9), “it may also be sensible to have those banking groups that operate on a truly European scale supervised directly by the central agency.” This is different from the Schoenmaker–Oosterloo model, where the focal point remains with the home supervisor.

Best of all worlds

Looking at the five criteria to judge the available policy options, the Schoenmaker–Oosterloo model (home on the basis of a European mandate) is the best supervisory structure to deal with the challenges posed by the growing interdependence of EU financial systems. This model follows the “decentralised” element of the lead supervisor concept promoted by the EFR, but adds the novel element of a European mandate promoted by Breuer to allow for adequate involvement of host country authorities.

Supervisory structures should adapt to market developments and not the other way round. The article therefore started by examining the current state of integration of EU financial

groups. There is a clear trend towards centralisation of risk management fostered by the advances of new risk modelling techniques and the move towards using internal models for capital (Basel II). Furthermore, the emergence of pan-European and regional banks has given rise to cross-border externalities from their (potential) failure.

National focus, European mandate

As a result of these market trends, it is increasingly difficult to organise financial supervision and stability on a predominantly national basis. This raises the question of where the appropriate division of responsibilities between home and host authorities, and their mandate (national or European), should be. To stay close to the operations of financial institutions, we argue that the supervisor in the home country should act as lead supervisor, but with a European mandate to incorporate cross-border effects. The focal point would remain at the national level, as the home supervisor would conduct the day-to-day supervision. The European mandate can be created through some form of European system of financial supervisors, created by the national supervisors in tandem with a centralised body. Key supervisory decisions as well as the design of policy would be made at the centre. In this way, host country authorities would be fully involved and the interests of their depositors fully taken into account.

Efficient supervisory structures are also important for the competitive position of EU financial institutions. A system with home-country supervision and no duplication by host countries with (slightly) different requirements and reporting formats (as is currently the case for subsidiaries) would reduce the burden on financial institutions and foster cross-border expansion within the EU. This would put European banks on a par with their counterparts in the United States, where the remaining barriers to interstate banking and branching were lifted in 1994.

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