

Supervising financial services in an integrated European Single Market:

A discussion paper

January 2005



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EXECUTIVE SUMMARY

As Europe's financial markets become more integrated, so the question of how to supervise these markets becomes more complex. Financial institutions quite reasonably demand more efficient supervisory arrangements to lower costs and to increase efficiency and competitive advantage, while investors and financial supervisors want supervisory arrangements that tackle cross-border risks more effectively.

There is no single or simple way to achieve supervisory convergence: the issues are complex and the solutions are multiple and multi-faceted. This paper sketches out five related challenges that need to be addressed to make progress on achieving convergence of supervisory practice, and offers some proposals for how this can be achieved. **Such proposals do not require new EU legislation but rather focus on practical solutions to this complex issue.** Taken together, these challenges and proposals present an ambitious framework for action:

- **to ensure the effective, consistent and proportionate implementation and enforcement of EU legislation on financial services.** This requires practical mechanisms which involve supervisors and the financial sector and which build on initiatives already underway;
- **to improve cooperation between supervisors.** There is plenty of scope within the existing legislative framework for more effective cooperation, including better information sharing, consultation and joint working. The UK authorities propose that the appropriate model of cooperation should be guided by a series of impact criteria based primarily on the systemic importance of an institution to the home or host Member State;
- **to ensure that the supply and sharing of data to, and between, financial supervisory authorities is efficient and effective.** Market initiatives to improve the efficiency of data flows need to be encouraged. Supervisors need to work together to define common data requirements for firms and reach agreement among themselves on adopting common formats or “languages”. One goal should be for firms to be able to supply data about their activities in one area (such as banking or securities trading) to only one supervisory authority;
- **to ensure that financial supervisory authorities, along with central banks and finance ministries, are able to work together to manage financial crises.** Cemented in deeper trust between supervisors, practical mechanisms are needed that allow supervisors to take decisions quickly and fairly, such as crisis management exercises embedded in Memoranda of Understanding and joint working; and
- **to continue to develop trust between market participants and supervisors and between supervisors themselves.** Supervisory authorities – and national governments – must have trust and confidence in each others' judgements and actions. Firms and consumers must also have trust in supervisory authorities. The best ways to increase trust are to increase transparency, for example by publishing national rulebooks or being open to peer review; to work more closely together; and to address conflicts of interest.

INTRODUCTION

1.1 Developing a Single Market in financial services lies at the core of EU Member States' commitment to economic reform in Europe.

The FSAP **1.2** Over the past five years the EU Financial Services Action Plan (FSAP) has been the legislative framework for developing a Single Market in Financial Services. Between its endorsement by the European Council in Lisbon in March 2000 and the end of December 2004, 39 out of the 42 FSAP measures have been adopted in the EU.

Lamfalussy arrangements **1.3** In parallel with the legislative phase of the FSAP, new structures have been established under the Lamfalussy arrangements to make the process of developing, implementing and enforcing financial services legislation more effective and transparent.

1.4 Initially for securities markets, the Lamfalussy arrangements have now been extended to banking and insurance and occupational pensions. These arrangements include:

- so-called Level 2 committees of finance ministries – the European Banking Committee (EBC), the European Insurance Committee (EIC), which includes pensions, and the European Securities Committee (ESC) – which agrees implementing measures for EU financial services legislation that can more easily be adapted to account for technical or market directives; and
- so-called Level 3 committees of national supervisory authorities – the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR) – which provide the Commission with specialist advice in preparing technical implementing measures for European Directives and promoting enhanced co-operation and convergence of supervisory practices across the EU.

1.5 As the FSAP nears completion, policy makers, industry practitioners and users of financial services are discussing the extent to which the Single Market has been achieved and the next steps to financial services integration. Important contributions to this debate include the Report on Financial Integration¹, prepared by the Financial Services Committee (FSC) and endorsed by the June 2004 ECOFIN, and the work of four independent expert groups² established by the European Commission to advise it on future strategy towards financial services in the EU.

UK's five priorities **1.6** The UK authorities' contribution to this debate was set out in *After the EU Financial Services Action Plan: A new strategic approach*³, which set out five priorities that should guide further action in developing a Single Market in financial services. These five priorities are summarised in Box 1.1.

¹ FSC Report on Financial Integration, Report of the Financial Services Committee to the Council, FSC4156/04, 17 May 2004.

² Expert Group on Banking Final Report (May 2004); Securities Expert Group Final Report (May 2004); Expert Group on Insurance and Pensions Final Report (May 2004); Asset Management Expert Group Final Report (May 2004).

³ *After the EU Financial Services Action Plan: A new strategic approach*, HM Treasury, Financial Services Authority and Bank of England, May 2004.

Box 1.1: The UK's five priorities

The UK authorities' five priorities for further financial services integration in the EU are:

- **better implementation and enforcement of EU measures affecting the financial sector.** A significant number of the FSAP measures that have been adopted have still to be implemented nationally. That should be a top priority, together with their subsequent enforcement;
- **alternatives to EU regulation.** In general, EU legislation should be a last resort and alternative approaches to policy making, such as more use of EU competition policy, market-based solutions and initiatives at national level, should be considered first;
- **better regulation.** In some specific cases, market failure analysis may demonstrate that further new EU legislation in financial services could be necessary. When new EU legislation on financial services is being considered a proper assessment of the costs and benefits should be undertaken and financial market participants should be fully consulted;
- **making the Lamfalussy arrangements work well.** These new regulatory arrangements are now in place to supervise financial services across the EU. They have been shown to work for securities markets and are being extended to banking and insurance. They need to be further developed; and
- **recognising the global nature of financial services.** It is crucially important to remember that financial markets are global. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based firms and financial centres. International action will sometimes be needed to tackle global issues.

SUPERVISING EUROPE'S FINANCIAL MARKETS

1.7 Responsibility for supervision of financial markets and firms in the European Union is entrusted to national supervisors of each of the 25 EU Member States.

Mutual recognition

1.8 The concept of "mutual recognition" lies at the heart of much of the legislation providing for the supervision of a European Single Market in financial services. Mutual recognition allows broadly equivalent regimes based on common core standards to be recognised, and have validity in, different Member States across the EU. This approach allows for some diversity but requires a degree of commonality of approach in regulation that is capable of producing broadly equivalent outcomes, in particular common core standards.

1.9 As Europe's financial markets become more integrated through the completion of the FSAP, the question of how best to supervise them becomes more complex. Financial integration increases the ability of firms to operate cross-border and the ease by which consumers can purchase products, either originated, or sold, by firms outside their own Member State.

Global markets

1.10 It is important to remember that the financial services industry is global in reach and that supervisory measures should include consideration of the international competitiveness of EU-based firms competing globally. Consequently, there will be occasions when EU supervisors will need to cooperate with other authorities to develop

common international standards and practices to deal with those supervisory issues that transcend Europe's borders.

An emerging debate

1.11 Recently, and most notably at the European Commission's conference on financial integration on 22-23 June 2004, a debate has developed about the supervisory approaches to increasingly integrated financial markets. This debate has been triggered by a combination of:

- **supervisory concerns** about the changing nature of risks arising from structural changes in the financial sector. For example, CESR has recently published a consultation paper on supervisory tools⁴;
- **growing demand from firms, especially groups with subsidiaries in several Member States, for a more streamlined approach** to cross-border financial supervision. These demands were highlighted in the four independent expert group reports to the European Commission on future strategy towards financial services in the EU and, for example, in a paper by the European Financial Services Round Table⁵; and
- **concerns of consumers and investors**, who need both the confidence to purchase, or invest in, the financial products of cross-border firms and reassurance about the supervisory arrangements. They also need to know that they may have recourse to the necessary redress mechanisms in the event that they require them.

1.12 This discussion paper – prepared jointly by the Treasury, Financial Services Authority (FSA) and Bank of England – is a contribution to the discussion on the supervision of increasingly integrated financial markets in Europe although many of the themes it addresses are applicable to the global commercial environment where many EU firms operate. It develops themes that were originally set out by the UK authorities in its response to the four expert group reports that were published in May 2004⁶. Moreover, its analysis deliberately spans the banking, market infrastructure⁷, insurance and securities sectors, reflecting the UK authorities' belief that, although the challenges in individual sectors will vary, there are important general themes and issues that can be best understood by an integrated and wide-ranging analysis.

TIMETABLE

1.13 The debate about supervisory convergence will be played out in the EU institutions through decisions about future strategy towards financial services in Europe and decisions on specific EU legislative proposals. The UK authorities believe that market participants, consumers, supervisory authorities and governments from across the EU need to be involved in this debate, which is likely to continue throughout 2005 and beyond.

⁴ *Which supervisory tools for the EU securities markets? An analytical paper by CESR, Committee of European Securities Regulators (CESR), October 2004.*

⁵ *Towards a lead supervisor for cross border financial institutions in the European Union, Recommendations of the European Financial Services Round Table, European Financial Services Round Table, June 2004.*

⁶ *After the EU Financial Services Action Plan: UK response to the four independent expert groups, HM Treasury, FSA and Bank of England, September 2004.*

⁷ The term 'market infrastructure' in this paper refers to financial institutions, entities and systems that carry out the clearing and settlement of market transactions.

1.14 The UK authorities would welcome comments on the ideas expressed in this discussion paper. These can be sent to: efs@hm-treasury.x.gsi.gov.uk.

2

DRIVERS FOR BETTER SUPERVISION OF INTEGRATING MARKETS

NATIONAL SUPERVISION AND CROSS-BORDER BUSINESS

2.1 Financial institutions may provide and market services to customers in another EU Member State (or indeed a country outside the EU) in a number of ways, including through:

- establishing¹ a **branch**;
- establishing a **subsidiary**;
- providing services on a **cross-border** basis (either directly, for example by telephone, or via an intermediary or distribution channel in the local market of the end-user);
- **strategic partnerships** with institutions in another Member State; and
- breaking down their value chain and locating different **functions** in different Member States.

2.2 The regulatory issues raised by such cross-border activities can be:

- prudential risk (which may, or may not, be a source of systemic risk);
- conduct of business;
- money-laundering and financial crime; and
- market, investor and consumer confidence.

2.3 Businesses, supervisory authorities and consumers of financial services all have an interest in arrangements that ensure effective and efficient supervision within an integrated market. The development of these arrangements – including cooperation between supervisory authorities – is broadly termed supervisory convergence.

WHAT DO FINANCIAL INSTITUTIONS WANT FROM SUPERVISORY ARRANGEMENTS?

2.4 Typically, financial institutions (banks, insurance companies, investment firms etc) are keen to see greater cooperation, coordination and convergence of supervisory practice in the EU for the following reasons:

- **efficiency.** Many firms see supervisory convergence and cooperation as essential to reaping the potential benefits from economies of scale and scope². Some firms argue that dealing with multiple supervisors imposes costs that, in part, offset the benefits of the Single Market. This will be particularly true where EU legislation is implemented or applied in an inconsistent manner by different supervisors. Pressures for more efficiency arise, for example, because:

¹ Establishment can include setting up a branch (or subsidiary) from scratch or buying or merging a local branch network.

² As an example, HSBC claimed in its Annual Report, 2004, to have dealings with 370 financial supervisors and central banks in 79 countries.

- financial conglomerates would like to reduce the number of supervisors with which they deal;
- cross-border firms typically organise themselves across business lines rather than by national boundaries, and would prefer supervisory arrangements not to inhibit this;
- similarly, firms that operate across the EU would like to optimise the level of capital required to offset risks in each geographical location³;
- some firms believe that there is scope for increasing efficiency by providing data on a more standardised basis, or reducing the number of financial supervisors to which they provide such data; and
- many financial institutions would also like to see faster handling of issues by supervisors, which is a particular concern for cross-border institutions where delays by one supervisor can have knock-on impacts elsewhere;
- **fair competition.** Firms do not want to face discrimination (which is prohibited under EU law) and typically want to be subject to regulatory burdens that are broadly equivalent to those applied to competitors in other Member States;
- **global competitiveness.** Developing greater efficiency is seen as critical in retaining and increasing the global competitiveness of EU-based financial institutions and financial centres in the EU; and
- **high quality, evidence-based and proportionate regulation.** Business believes that the quality and proportionality of regulation itself is a key factor in influencing competitiveness. Many believe that the convergence of supervisory practice has a role to play in influencing the quality of the regulation and supervision that they face.

WHAT DO FINANCIAL SUPERVISORS WANT FROM SUPERVISORY ARRANGEMENTS?

2.5 For their part, supervisory authorities and others with an interest in financial stability and supervisory issues generally, support both more efficient cooperation and further convergence of financial supervision for the following reasons:

- **effectiveness in dealing with cross-border risks.** Effective arrangements are needed for supervising firms on a day-to-day basis. This is easier to achieve if there is greater convergence of standards and practices, coupled with cooperation and mutual reliance between supervisory authorities. Supervisors typically want to ensure that appropriate coordination and information sharing arrangements are in place at a national, EU and international level, for handling situations with all relevant authorities. This also applies to ensuring that where opportunities for regulatory arbitrage exist, they are not permitted to undermine core EU standards and consumer protection;

³ Research by CSFB suggests that operational risk charges increase by 80 per cent if based on geographical rather than business lines.

- **efficient resolution of cross-border financial situations.** Finance ministries, central banks and supervisory authorities will want to ensure the availability of an appropriate “tool kit” of responses, at both a national and EU level, for handling situations with all relevant authorities. This debate is anchored in the follow-up to the Brouwer reports⁴. This also applies to ensuring that where opportunities for regulatory arbitrage exist, they are not permitted to undermine core EU standards and consumer protection;
- **responding to the way that firms do business.** As discussed above, large firms typically organise and manage important functions such as liquidity and treasury management on a global (or at least pan-European) basis. Approaching their supervision in a manner which recognises these developments can contribute to the effectiveness, as well as the efficiency, of supervision; and
- **fair competition.** Like firms, authorities want to ensure supervisory practice assists fair competition within the Single Market.

WHAT DO CONSUMERS WANT FROM SUPERVISORY ARRANGEMENTS

Consumer confidence 2.6 As financial markets become more integrated, consumers should find it easier to purchase products cross-border in any of the models identified at the start of this chapter. As a result, consumers will also have an interest in efficient, well functioning supervisory arrangements that:

- provide **confidence** that they are able to purchase financial services from firms in other Member States and will be covered by broadly equivalent levels of protection; and
- ensure they have recourse to the necessary **redress mechanisms** (including guarantee schemes) if and when they need them.

LIMITATIONS TO INTEGRATED SUPERVISORY ARRANGEMENTS

2.7 However, there are also arguments, explored further in Box 1.2, that highlight the potential drawbacks of pursuing supervisory convergence without regard to other considerations which also need to be taken into account:

- one of the advantages of having multiple supervisors dealing with an individual financial institution in different ways is that they have **local knowledge** of the firms’ operations and understand how this can interact with other risks;
- **diversity of markets.** Financial markets, whilst increasingly global, nevertheless tend to reflect differences between Member States. Diversity need not be a bad thing. These differences are most pronounced in retail financial markets. Individual national supervisors may therefore prefer to adopt their own specific national supervisory responses and solutions to challenges that this diversity poses;

⁴ *Report on financial stability*, Economic and Financial Committee, EFC/ECFIN/240/00, May 2000 and *Report on financial crisis management*, Economic and Financial Committee, EFC/ECFIN/251/01, May 2001.

- **diversity of regulatory standards** can sometimes help support innovation and competition between markets. For example, differences in listing rules may be a key factor in differentiating equity markets in the eyes of investors. Any pressure for consistent approaches to supervision needs to keep the necessity for competitiveness and innovation in mind; and
- **limitations to cooperative arrangements.** Ultimately, each supervisor, central bank and finance ministry is domestically accountable while also subject to EU law. This line of responsibility might potentially constrain the delegation of responsibility in some circumstances.

Box 2.2: The difficulties of a single rule-book in the EU

Proponents of the idea of a single rule-book governing all financial services provided within the EU argue that it would free firms to compete on the basis of the same rules and remove from them the expense of complying with up to 25 different domestic regimes.

The concept of a single rule-book, while having some superficial appeal, ignores some fundamental realities. As regards wholesale markets, the EU has broadly completed the legislation set out in the FSAP. When implemented by Member States, this legislative programme will reinforce a single wholesale market and enable firms to provide services across the EU on the basis of a single set of core requirements – those of their home state or country of origin. This is not a single EU rule-book, but it achieves broadly the same result for firms, professional investors and issuers while accommodating the diversity of national markets and local practices.

As regards retail markets, the EU recognised at the Lisbon European Council in 2000 that consumers need greater levels of protection than businesses, and that the objective of providing an open and secure retail market for consumers has to be based on the fact that national retail markets, and the infrastructure supporting them, differ widely. These variations reflect differences in state provision of pensions, health and social services, patterns of savings and investment, demographic trends, and levels of product choice, innovation, competition, consumer knowledge and appetite for risk.

Any attempt to draw up a single rule-book for Europe's retail markets would need to address the requirements of this diversity. The result would be an unhappy compromise between two conflicting demands:

- a desire not to lose any of the protections in any of the Member States which would lead to a rule-book that contained the existing rules of all Member States; and
- a desire to ensure a measure of proportionality and to retain a competitive environment. A single rule-book that addressed market failures which are manifest in only one or two Member States would almost certainly be disproportionate in others.

Finally, while a single rule-book would in theory lead to a single regulatory regime, it would not provide a single legal regime. When providing retail services in other Member States, firms would still have to be aware that they could be subject to the jurisdiction of the courts of the country of the consumer, and that these courts would often apply their own law to the facts at issue.

PRESSURES ON THE CURRENT EU ARRANGEMENTS

2.8 The primacy of home country prudential supervision for branches and host supervision for subsidiaries, supplemented with a variety of informal cooperative measures at the practical level – discussed in more detail in Chapter 4 – has worked reasonably well to date. However, it is reasonable to ask how they will face emerging pressures – both market and policy driven. The pressures include:

- **possible increases in the number and importance of potentially systemic (mainly bank) branches.** This is partly an aspect of broader European integration but the concern is heightened by the accession of new Member

States to the EU⁵. Most of the foreign banks in the accession countries are currently constituted as subsidiaries, but there is scope for these to be changed into branches in future. There are also examples within the EU15, such as Nordea, of firms with plans to move to a branch structure;

- **the availability of a new EU corporate form**, under the European Company Statute⁶, may facilitate the transformation of subsidiaries into branches;
- **much market infrastructure is now part of larger cross-border groupings**, operating in a number of countries. Where these groups operate in Member States through a branch or remote access, concerns about loss of national supervisory control of potentially systemically important operations might be raised; and
- **EU legislative initiatives** to introduce more streamlined arrangements for supervising cross-border groups, resulting from growing number of calls for the removal of inconsistencies and duplication. Such initiatives were initially introduced through the Financial Conglomerates Directive (FCD), and now in the context of new prudential capital frameworks for banks and investment firms, through the proposed Capital Requirements Directive (CRD), and, in due course, for insurers through the planned Solvency II Directive. The European Commission has also indicated it believes that the home supervisor model might need to be adapted for the “specificities” of clearing and settlement in any clearing and settlement directive⁷.

Challenges 2.9 These pressures collectively pose a number of challenges for the existing approaches. Perhaps the two most important relate to ensuring that supervisory models appropriately address:

- growing disparity between the potential **systemic importance** of some branches or services supplied cross-border and the amount of host country oversight of them; and
- balancing the need for more **cost-efficient supervision** of groups which increasingly manage their activities and risks on a group-wide basis against the need of supervisors of the group and its component parts to meet their objectives.

2.10 For supervisory authorities in particular, such challenges are likely to be especially acute in circumstances such as where:

- **a firm is potentially systemic to the host, but not the home Member State** – and so the emphasis of supervisors’ interests may not be fully aligned. Where the entity in the host Member State is a branch, the host supervisor may have limited scope for identifying sources of systemic risk and will certainly lack tools to deal directly with these. Foreign-owned banks might fall into this category for some EU countries;

⁵ Cross-border ownership already exceeds 70 per cent in the banking systems of Slovakia, Estonia, Poland and Hungary, compared with the EU15 average of 30 per cent.

⁶ Council Regulation 2001/2157/EC of 8 October 2001.

⁷ *Clearing and Settlement in the European Union – The way forward*, Communication from the Commission to the Council and the European Parliament, 9224/04 of 5 May 2004.

- **a firm is potentially systemic in both the host and home Member States** – and there is a question as to whether the home supervisory authority would be in a position from a practical perspective to remedy problems in the host country effectively. Market infrastructure providers might fall into this category for many EU countries;
- whether or not any individual entity is potentially systemic, **much of the host Member State’s banking (or insurance) system is foreign-owned**, so that in aggregate its authorities have limited responsibility for supervision within their financial market. This could be an issue for many new EU Member States; or
- **market pressure leads firms to the centralisation of important functions, such as liquidity and portfolio risk management in one jurisdiction.** Supervisory authorities must therefore ensure that they have access to the necessary information to oversee all relevant operations of the firm.

3

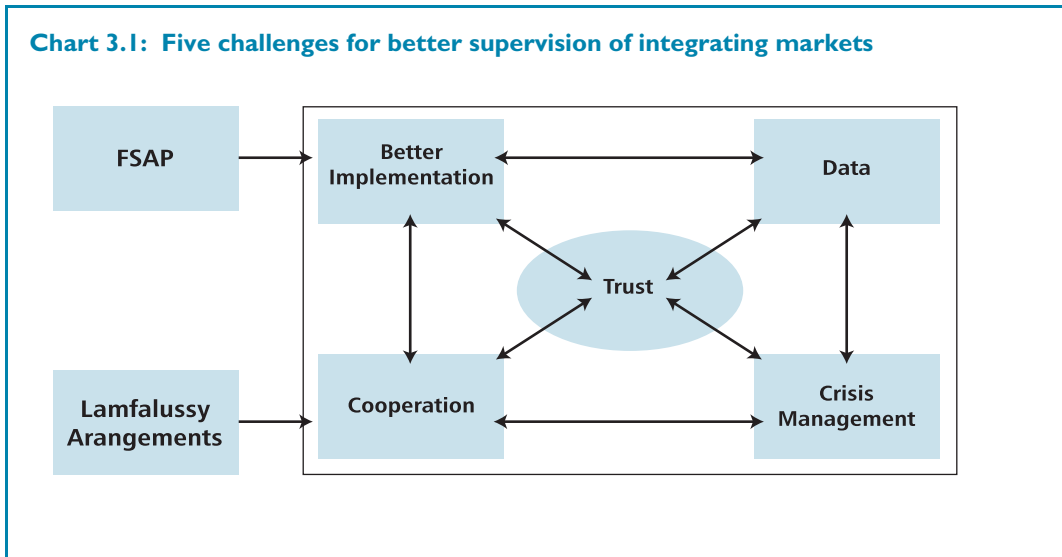
STRENGTHENING SUPERVISION OF INTEGRATING MARKETS

Five challenges 3.1 From the analysis set out in Chapter 2, it is clear that the issues surrounding better supervision of integrating markets are complex and there is likely to be no single best solution to the supervisory issues that arise. Rather, appropriate solutions will be multiple and multi-faceted.

3.2 Nevertheless, the UK authorities believe it is possible to discern five key challenges, again drawing upon the analysis contained in Chapter 2, that better supervision of integrating markets needs to address. They are:

- to ensure the effective, consistent, proportionate **implementation and enforcement** of EU legislation on financial services so as to ensure that the level of integration and economic benefits foreseen under the FSAP materialise;
- to improve **cooperation** between financial supervisory authorities in particular to develop workable and efficient supervisory arrangements for branches and subsidiaries and the issues for supervision that they pose;
- to ensure the supply of **data** to, and sharing between, financial supervisory authorities, is efficient and effective so as to enable firms to benefit from greater efficiency and the avoidance of duplication in the supply of data to multiple supervisors;
- to ensure that financial supervisory authorities are able, alongside the central bank and finance ministries, to work together to both prevent the occurrence of **financial crises** wherever possible, as well as to ensure appropriate arrangements are in place to manage financial crises where necessary; and
- to continue to develop **trust** between market participants and supervisors and between supervisors themselves so as to assist in achieving all of the above.

Chart 3.1: Five challenges for better supervision of integrating markets



IMPLEMENTATION AND ENFORCEMENT

Greater consistency

3.3 As indicated in Chapter 2, financial institutions and supervisory authorities would both welcome greater consistency in the rules governing cross-border financial institutions and their application. This would improve the efficiency for firms engaged in cross-border business while also helping to achieve supervisory objectives. The desire of firms for more consistency is amply demonstrated in the four independent expert group reports of May 2004 and the work of the European Financial Services Round Table.

Practical steps

3.4 The UK authorities have set out their own views on how rules might be better implemented and enforced across the European Union, including to achieve greater consistency¹. These views are summarised in Box 3.1.

¹ See: Chapter 2 of *After the EU Financial Services Action Plan: A new strategic approach*, HM Treasury, FSA and Bank of England, May 2004; Chapter 2 of *The EU Financial Services Action Plan: Delivering the FSAP in the UK*, HM Treasury, FSA and Bank of England, May 2004; and paragraphs 2.4-2.8 of *After the EU Financial Services Action Plan: UK response to the reports of the four independent expert groups*, HM Treasury, FSA and Bank of England, September 2004.

Box 3.1: Practical ideas for improving implementation and enforcement across the EU

The UK authorities welcome the work that is currently being coordinated by the European Commission and involving CEBS, CEIOPS and CESR identifying practical mechanisms to ensure that financial services legislation is implemented effectively and consistently across Member States. Such an approach is crucial to enable businesses to operate within a Single Market, while avoiding unnecessary burdensome regulation. The UK therefore:

- supports the introduction of national “**single contact points**” to monitor and report back to the Commission on Member States’ progress in implementing EU financial services legislation into national law;
- supports the use of “**transposition working groups**” of national experts who draft national implementing legislation to provide information sharing, for example of best practice;
- supports the use of **transposition tables**, to demonstrate clearly the link between provisions in a directive and their corresponding provisions in national law and to compare transposition across Member States;
- believes that **peer group review** is potentially a useful way forward to help raise standards of implementation in many contexts; and
- supports the introduction of more effective, rapid and transparent cross-border **complaints and mediations procedures** for financial services to resolve problems identified by businesses and consumers.

3.5 In addition to the practical steps set out above, more consistent rules might be achieved by a combination of some or all of the following ideas:

- more consistent transposition and implementation of EU law in Member States;
- greater use of regulations rather than directives at an EU level where circumstances warrant²;
- more consistent approaches to enforcement of rules in each Member State;
- more transparent and effective mechanisms to resolve differences in implementation and enforcement; and
- greater cooperation between the Lamfalussy Committees to ensure cross-sectoral consistency in the implementation and enforcement of EU directives.

Allocating resources **3.6** Finally, it should be noted that the Financial Services Committee, the ECOFIN Council and the four independent expert groups have concluded that implementation and enforcement of existing FSAP measures should have overall priority. It will

² The distinction between regulations (which have direct effect in Member States and therefore do not necessarily require implementation) and directives (which typically require implementation by the authorities in each Member State to have effect) is set out more fully in paragraphs 1.10-1.11 of *The EU Financial Services Action Plan: Delivering the FSAP in the UK*. While regulations offer some benefits in some circumstances, there are also drawbacks in other cases, often for the same reasons as set out in Box 2.2.

therefore be essential for the Commission, which plays a central role here, to ensure it devotes sufficient resources from within its overall budget to realise these wishes. The UK authorities call on the new Commission to include, with the publication of its forthcoming work programme and in any communication about its future approach to financial services, a statement setting out how it is reallocating its resources to ensure that this priority is realised.

Box 3.2: UK commitments for improving implementation in the UK

The UK authorities have made a number of commitments to ensure that financial services measures are implemented effectively, proportionately and consistently in the UK, including:

- to develop and publish cost-benefit analyses of different approaches to implementation;
- to provide at least three, and where possible, six months of certainty before firms are required to operate to new rules;
- to avoid going beyond the minimum necessary to comply with a directive unless there is a demonstrable case for doing so;
- to require emerging European legislation, with significant costs for business and measures to implement this legislation in the UK, to be given tough scrutiny by the Prime Minister's Panel for Regulatory Accountability;
- to consult industry before taking decision on implementation and to produce a regulatory impact assessment at an early stage of the implementation process; and
- where possible, to take into account the approaches taken by other Member States in implementing financial services directives.

The UK's approach to implementing the FSAP was set out in detail in *The EU Financial Services Action Plan: Delivering the FSAP in the UK*³ and for implementing EU legislation more generally in the 2004 Pre-Budget Report⁴.

COOPERATION

Dealing with cross-border risks

3.7 Cooperation between financial supervisors is essential to allow them to deal effectively with emerging cross-border risks, both market-wide and firm-specific. It should also help to facilitate a more "joined up" approach to supervising individual firms, which increases efficiency for firms and end-users. Ideas for further consideration to help to achieve these two objectives might include:

- supervisors deciding to **allocate casework** on individual institutions or activities carried out by those institutions. This need not involve any change in formal accountabilities, but would involve an authority being willing to rely on, and trust, the work undertaken by a supervisory authority in another Member State;
- having **joint casework** arrangements; and

³ *The EU Financial Services Action Plan: Delivering the FSAP in the UK*, HM Treasury, FSA and Bank of England, May 2004.

⁴ *2004 Pre-Budget Report*, HM Treasury, December 2004.

- ensuring that the **remits of national supervisory authorities** allow, and in some cases require, cooperation with other national supervisory authorities in the same Member State (in those cases where responsibilities are split between different authorities) and between supervisory authorities in other Member States. The objective would be to ensure that supervisory activities are appropriately coordinated.

3.8 Integral to the discussion of cooperation is the allocation of legal responsibilities between home and host supervisors. This issue and the subject of practical cooperation between supervisors are discussed more fully in Chapter 4, especially for circumstances relating to systemic risks.

DATA

3.9 Financial markets rely on the efficient flow of data, from:

- **firm to firm.** Firms rely on the supply of data from other firms (for example, exchanges making available the prices at which traders are willing to buy or sell securities, or banks reporting aspects of their capital allocations to the market as part of the proposed third pillar of market discipline under Basel II). Some firm to firm data flows are of an exclusively commercial nature. Others, however, may arise from regulatory obligations and may raise public policy issues in how they are discharged;
- **firms to supervisors.** Firms supply data (for example about securities trades or about their financial soundness) on which supervisory authorities rely; and
- **supervisors to supervisors.** In an increasingly integrated market, supervisory authorities rely on the flow of data from each other to be able to carry out day-to-day supervision and carry out investigations (for example to understand the capital position of the parent of a financial group with subsidiaries in other countries).

Enhancing data sharing and collection

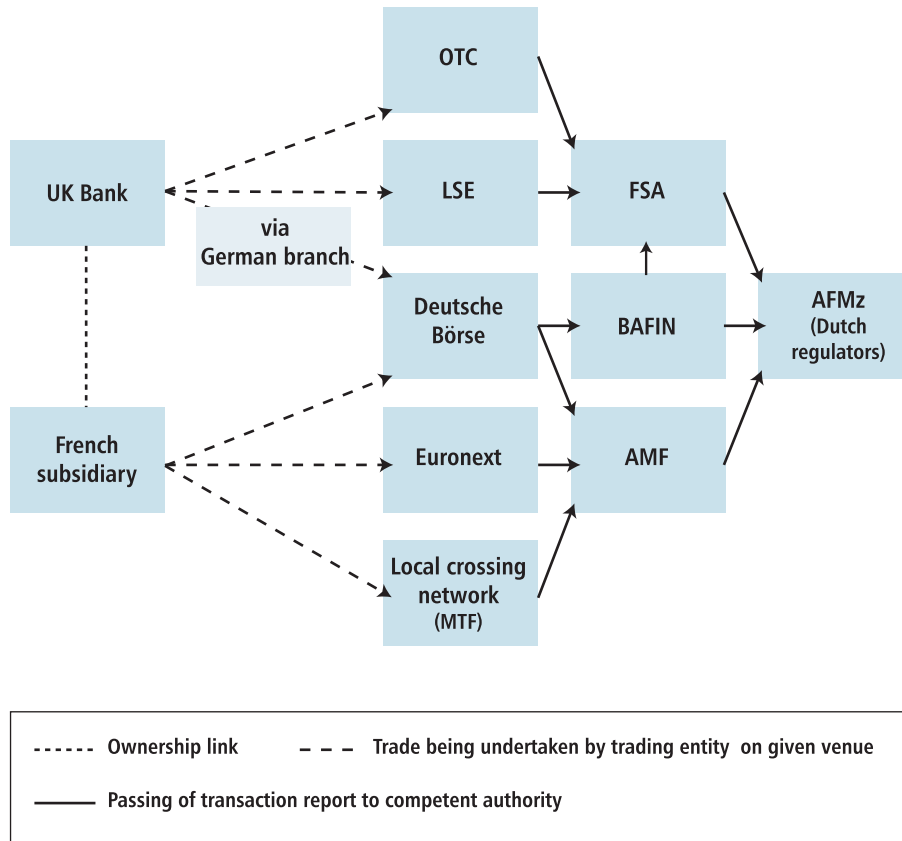
3.10 It follows that if there were opportunities to improve the sharing and collection of financial market data, these might bring advantages to supervisors and financial institutions, for example:

- **reduced costs** for firms if they can supply a single set of data to supervisory authorities, rather than supplying different data or data in different formats to each authority. The work of CEBS in developing a harmonised framework for regulatory reporting is a good example of this;
- common data formats would make it easier to provide, for example, a consolidated tape or quote montage of trading data, encouraging **competition** between trading venues and **easier monitoring** of best execution obligations. Such common formats would also advance clearing and settlement interoperability, as recognised by the G30 and Giovannini reports; and
- supervisory authorities would be able to analyse and interpret data on the activities and financial soundness of cross border firms more easily if it were in a common format. This might help them **monitor and address cross-border risks** better. Improved access to shared data might also enable

supervisory authorities to **cooperate** more effectively and to **prioritise** their own resources better.

3.11 Nevertheless, there are currently few common data standards, formats or minimum requirements and as a result, a significant amount of fragmentation has arisen in the provision of data from firms to supervisory authorities. This is illustrated in Chart 3.2.

Chart 3.2: An example of data fragmentation



In this example, a UK bank trades a Dutch stock: 1) on the LSE; 2) in OTC space in London; and 3) on Deutsche Börse via a German branch. In addition, the bank owns a French subsidiary that trades the same Dutch stock: 1) on Euronext; 2) remotely on Deutsche Börse; and 3) on a local crossing network (an MTF). The UK bank has to transaction report both its trades to FSA. The German branch transaction reports to the BAFIN, its host authority. As the home country supervisor of the branch, FSA can require BAFIN to forward the transactions reports made by the branch. The French subsidiary has to make transaction reports for the Euronext and MTF trades to the AMF. The trade it executes as a remote member of Deutsche Borse also has to be reported to the AMF and, as things presently stand, to the BAFIN. FSA, BAFIN and AMF all have to forward the transaction reports they receive in Dutch securities to the AFM (assuming the most liquid market for the security is Euronext Amsterdam)

3.12 However, in pursuing any such opportunities, it is essential that:

- it is done on the basis of a proper **analysis of the costs and benefits** – including the costs of changing systems for firms. As a general matter, regulatory demands which require firms to produce data significantly

beyond what they require for day-to-day management purposes, need to be rigorously justified; and

- negative impacts on **innovation and competition** are avoided.

3.13 Many of these ideas have already been raised by the financial services sector, for example in the four independent expert group reports. There are a number of areas where work on data is currently being pursued, in some cases flowing from requirements set out in EU legislation⁵. Some examples relating to equity trading are shown in Box 3.3.

Box 3.3: Work under way on equity data sharing

Cross border clearing and settlement initiatives. The G30, Giovannini Group, ESCB-CESR and CPSS-IOSCO⁶ have issued separate recommendations on ways to improve the interoperability of EU clearing and settlement, including harmonisation of messaging standards, communication protocols and reference data standards.

Convergence of electronic messaging protocols. The independent messaging protocols FIX (mostly used for pre-trade space) and SWIFT (post-trade/confirmations) are working toward converging their two protocols in order to be compliant with the International Organisation for Standardisation's guidelines for the efficient design of securities messages (ISO15022). The convergence should bring about a single protocol or a pair of interoperable protocols, making their use easier for market participants.

Standardisation of reference data. The industry has been working to develop a pan-European or global set of individual legal entity identifiers to help minimise confusion about the entities to which securities messages refer. The Reference Data User Group has been working hard to move the industry's efforts forward with respect to this initiative and broader efficiency in the use, management and sharing of reference data.

Practical steps 3.14 The UK authorities believe that it would be worthwhile pursuing this theme further as a key practical element of supervisory convergence. They suggest that:

- **there may be cases where it will be in the public interest for authorities and market participants to work together** to encourage the development and wider use of data standards in the interests of promoting innovation and competition. Regulatory authorities have a direct interest in the second and third types of data flow referred to in paragraph 3.9 (i.e. from firms to supervisors and from supervisors to other supervisors). The authorities (including the competition authorities) also have an interest in the first type of data flow (i.e. from firms to the market). In this last case, the interest is triggered where it is apparent that standards of transparency, levels of innovation or of competition are inhibited by the existing market structure;

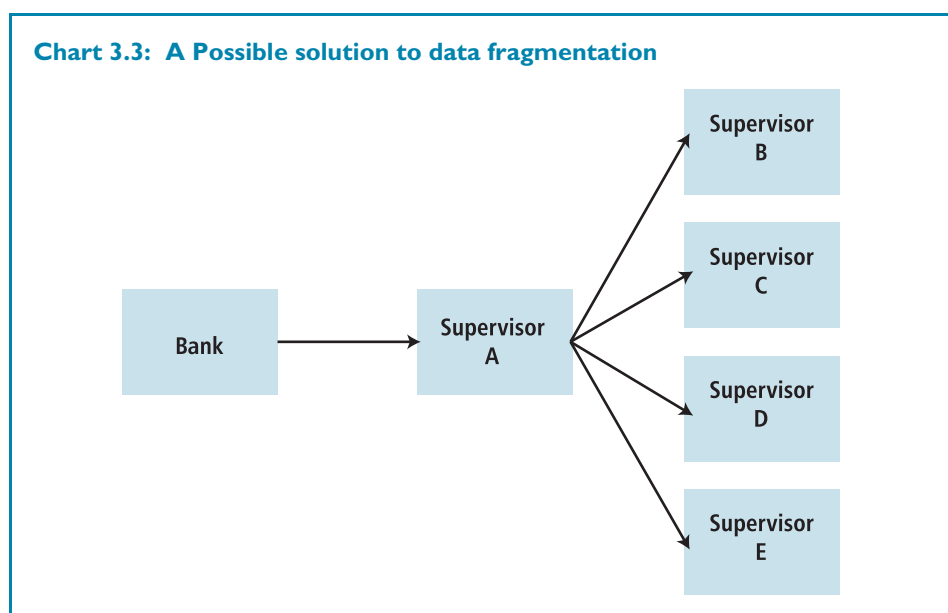
⁵ The Markets in Financial Instruments Directive and Transparency Directive both have provisions relating to data, which CESR and the Commission will be considering. The proposed Capital Requirements Directive (CRD) also requires exchange of information between supervisors. In 2005 CEBS will start a formal consultation process to achieve a common solvency ratio reporting framework for credit institutions and investment firms under the CRD.

⁶ The G30 comprises senior representatives of the private and public sectors and academia and meets to discuss International Economic and Monetary Affairs. The Giovannini Group comprises financial-market participants (chaired by Alberto Giovannini), which advises the European Commission on financial market issues. ESCB-CESR is a working group comprised of representatives from the ECB, EU national central banks and CESR, with the European Commission in attendance. CPSS-IOSCO is the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions which compiles recommendations for the design, operation and oversight of securities settlement systems.

for example, by the abuse of monopoly power or of a dominant market position;

- **supervisory authorities need to work together in the Level 3 committees to define common data requirements for firms and on common formats or “languages”** that simplify data provision and facilitate greater sharing of common data among supervisors. Agreements on standards (both on content and format) should not be hard-wired into legislation but should take the form of agreements at Level 3 so that they can be amended easily in response to technical innovation;
- **market participants should be fully involved in the work to develop data standards.** Supervisory authorities should build on the progress made by market participants to ensure that their own efforts are consistent with emerging best practices. Level 3 mechanisms should exist to ensure close communication by supervisors with standard setting bodies (eg. FIX, SWIFT) and with representatives from different market participants (exchanges, securities houses, information vendors, banks etc). This is particularly important because establishing data standards for information provided by firms to supervisors could have benefits in turn for data flows from firm to firm, helping drive standard setting more broadly;
- one goal for the future should be for firms to be able to supply data about their activities in one area (such as banking or securities trading) to only one supervisory authority, and for that data to be shared seamlessly with other supervisors to allow all those supervisors to carry out their current and future legal responsibilities. For the purposes of supplying data on that area of business activity, the firm would therefore interact with a single supervisory “one-stop-shop” or “front end”, irrespective of where in the EU that activity is being carried out, without disrupting the division of legal responsibilities between supervisory authorities. This is illustrated in Chart 3.3; and

Chart 3.3: A Possible solution to data fragmentation



- as stressed above, any proposed action by the authorities needs to be considered against a full analysis of the costs and benefits, and be developed in full consultation with relevant market participants. The timing of any actions is critical, in view of changing regulatory requirements and technological developments.

CRISIS MANAGEMENT

3.15 Understandably, arrangements for preventing and managing financial crises are a particular concern for financial supervisors, central banks and finance ministries. They should also concern financial institutions themselves, given that they need to be confident in arrangements to protect the markets from large scale disruption.

Practical steps 3.16 Building on the work of the ESCB's Banking Supervisory Committee (BSC)⁷ and the FSC⁸, potential ideas for improving crisis management arrangements include:

- ensuring that **supervisors' remits and objectives** permit them to take into account cross-border factors such as financial stability in other Member States when carrying out their functions;
- developing workable and effective **memoranda of understanding** (MoUs) between supervisors, central banks and finance ministries, both at a national level and across the EU. For example, the existing BSC MoU sets out principles for cooperation between central banks and supervisors in the event of financial crises with potential cross-border impact;
- undertaking frequent **crisis management exercises**, also at national and EU level;
- having **joint teams** ready to deal with any crises that emerge for each institution which has the potential to pose large cross-border risks; and
- continuing to develop effective **cooperative arrangements with non-EU countries**, given the global nature of financial markets.

3.17 The allocation of responsibilities between home and host authorities is especially important for firms that represent potential cross-border systemic risks. This is also considered in Chapter 4.

TRUST

3.18 Running through all of these factors is the need for trust:

- **firms** want to be able to trust financial supervisors to be fair and even-handed; and
- **supervisory authorities** need to be able to trust each other, including to take proper account of the wider, as well as the national, interest.

3.19 This is a difficult issue that takes time to resolve. Some mechanisms to strengthen trust are already in place, notably through the Level 2 and 3 committees, but further ideas worth exploring include:

⁷ http://www.ecb.int/press/pr/date/2003/html/pr030310_3.en.html.

⁸ *Developing a framework for managing financial stability problems in the EU*, a non paper by the Financial Services Committee, 22 July 2004.

- more **transparency between supervisors** (for example through the exercises conducted through CEIOPS to understand how supervisors take decisions regarding insurance firms, and peer review arrangements);
- **transparency to business** (for example by publishing national rulebooks in a manner which aids comparisons between countries, or consulting fully on the national transposition of EU directives);
- removing any potential **conflicts of interest** (for example between financial supervision and other aspects of public policy, such as promoting local financial markets or involvement in competition policy decisions);
- **training and help in developing capacity** in those Member States with less developed supervisory arrangements; and
- **secondments** between supervisory authorities.

4

PROMOTING MORE EFFECTIVE HOME-HOST COOPERATION

OBJECTIVES FOR MORE EFFECTIVE COOPERATION

Roles and responsibilities

4.1 The roles and responsibilities of financial supervisors in relation to cross-border financial institutions can be considered in terms of:

- the division of **legal** responsibilities between the home and host supervisory authorities (for example, which supervisor authorises a firm to carry out business and can impose disciplinary sanctions); and
- arrangements for the authorities to carry out supervision at the **practical** level, within the legal framework, often involving a large degree of cooperation (for example how the authorities carry out day-to-day supervisory monitoring).

4.2 The UK authorities believe that it is important to have supervisory arrangements in the EU that:

- are **efficient and effective** for firms and their customers;
- **safeguard financial stability and the reputation of financial markets** in the EU;
- maintain **market confidence**;
- are **clear about where legal responsibilities lie**;
- promote a **deepening of the Single Market**; and
- recognise that the integration of financial markets is a **global as well as European phenomenon**.

4.3 Ideal supervisory arrangements – from both the supervisors’ and firms’ points of view – would avoid:

- **gaps**. For example, without some form of explicit prompting, national supervisors may not fully internalise (i.e. take full account of) the interests of other authorities when dealing with cross-border financial institutions. The more important a particular firm or sector, the greater the likely concern over possible gaps in supervision (or, put the other way round, the more costly gaps in supervision are likely to prove); and
- **overlaps**. Where all national supervisors of a firm have supervisory powers, but cooperation is absent, each supervisor may impose overlapping (or in extreme cases, conflicting) supervisory requirements, increasing regulatory burdens for the firm. Firms have legitimate concerns about the additional compliance burdens posed by overlaps. As will be seen below, the problems posed by gaps tend to relate especially to issues with the supervision of branches, while those posed by overlaps tend to relate especially to the supervision of subsidiaries.

CURRENT ARRANGEMENTS

The basic EU approach

4.4 The basic EU approach to the division of legal responsibilities for cross-border financial supervision is enshrined in the Markets in Financial Instruments Directive (MiFID), the Banking Consolidation Directive (BCD) and the Life and Non-life Directives:

- **branches** are authorised and prudentially supervised by the home¹ supervisor². Conduct of business on the other hand is typically the host authorities' legal responsibility, unless provided for on a cross-border basis, when home country rules may apply in some areas³; and
- **subsidiaries** are, in general, treated as domestic firms, and thus are authorised and prudentially supervised by the host supervisor. So, for a subsidiary of a foreign firm in the UK, prudential supervision is the responsibility of the FSA. Conduct of business regulation for investment firms is also broadly the responsibility of the host, although the MiFID modifies this in some respects.

DEALING WITH THE PRESSURES ON CURRENT EU ARRANGEMENTS

Two opposing trends

4.5 Some of the challenges driving supervisory convergence were set out in Chapter 2. It is possible to discern two (opposing) trends that are emerging in relation to these challenges:

- the development of arrangements which give host supervisors more of a role in supervising **branches** (for example the provision for proportionate cooperation agreements in MiFID); and
- proposals for streamlining arrangements to give home supervisors more responsibility for supervising **subsidiaries** (for example, the proposals in relation to the group risk model approval in the proposed CRD).

4.6 To some extent these two trends might be expected to lead eventually to some convergence of the current branch and subsidiary supervisory models towards some middle ground in which there would be a “lead” supervisor (the current home supervisor), with host supervisors having well defined and definite, but ultimately secondary, practical roles.

4.7 However, it should be noted that important principles enshrined in EU legislation place some limitations on such convergence:

- any increase in formal host supervisor responsibility for, or legal powers over, branches could to some extent cut across the Single Market principle of **freedom of establishment** for firms from their home country, including

¹ For the purposes of Chapter 4, the “home” supervisor is taken to be the supervisor in the jurisdiction in which the parent firm is licensed, authorised or incorporated. This is the definition enshrined in EU legislation to date. The “host” supervisor is taken to be the supervisor in the jurisdiction in which a branch or a locally incorporated subsidiary are located.

² The exception to this rule is liquidity regulation which, in line with the Basel Concordat, remains the responsibility of the host, although in practice it may be delegated to the home supervisor.

³ This basic position is subject to a number of variants that are not exhaustively set out here. For investment services, banks and insurance legislation, for example, the location of the client is not relevant in determining whether a cross-border service is being provided, while e-commerce allocates responsibility on the basis of the Member State from where the service is provided, i.e. the provider’s “country of origin/establishment” – which could be either the home or host state.

those based on “passporting” rights provided in directives⁴. Greater host supervisor responsibility, if applied inappropriately and without the necessary co-ordination of regulation would increase the costs of supervision for branches, which would conflict with the desire for more efficiency within the Single Market; and

- greater home supervisor responsibility for, or powers over, groups (specifically supervision of the highest holding company in the EU) could be seen as cutting across the **legal responsibilities of host supervisors** for authorising subsidiaries.

A practical approach 4.8 Any proposals for significant radical changes to the division of legal responsibilities between home and host supervisory authorities should be approached with great care and are unlikely to be feasible. The UK authorities believe that the EU should seek approaches which:

- **work with the framework of the current division of legal responsibilities** between home and host supervisors, including making more effective use of the various approaches to cooperation between home and host supervisors that are currently enshrined within EU legislation;
- **ensure that explicit allowance is made within new directives** for appropriate home-host collaboration; and
- **focus especially on effective cooperation at the practical level** between home and host supervisors. Again, there is already a diverse range of models for cooperation in the EU that should be elaborated and promoted through Level 3 cooperation.

TOOLS FOR PROMOTING MORE EFFECTIVE COOPERATION

Using existing tools 4.9 There are two principal tools that need to underpin, and form the basis of, any framework to enhance the supervision of firms engaging in cross-border business. These are:

- the existing **legal framework**, as set out in current EU directives; and
- the existing (and newly extended) **EU Lamfalussy supervisory arrangements** and structures.

4.10 The basis of the existing legal framework is summarised in paragraph 4.4. However, the existing legal arrangements show much greater subtlety for dealing with specific circumstances. These are summarised in table 4.1.

⁴ As enshrined in the BCD for example.

Table 4.1: Existing Directive Provisions

Sector	Information-sharing	Other forms of cooperation	Emergency powers
Banking	Article 131 draft CRD Article 14 FCD	Article 132 draft CRD Article 12 FCD	Article 22 BCD
Insurance	Article 16 3rd NLD Article 16 CLD Article 14 FCD	Article 14 FCD	Article 40 3rd NLD Article 46 CLD
Investment firms	Article 58 MiFID Article 14 FCD	Article 14 FCD	Article 62 MiFID
Regulated markets	Article 58 MiFID Article 14 FCD	Article 56 MiFID (for regulated markets) Article 14 FCD	Article 62 MiFID
Notes: BCD : Banking Consolidation Directive; CLD : Consolidated Life Directive; CRD : Capital Requirements Directive; FCD : Financial Conglomerates Directive; MiFID : Markets in Financial Instruments Directive and NLD : Non-Life Directive.			

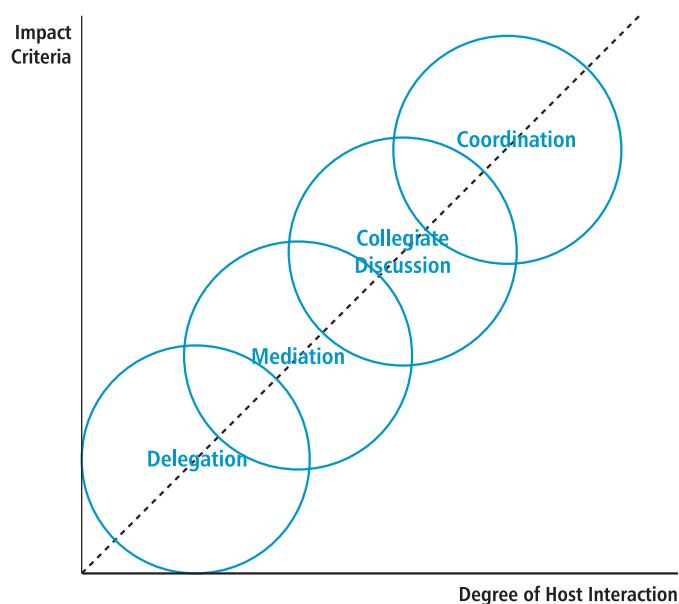
Various forms of cooperation

4.11 To summarise Table 4.1, there are several approaches in existing EU law that could be said to address situations where greater supervisory involvement is regarded as necessary for the local supervisor (whether home or host). They include:

- **information exchange** where the home and host supervisors share relevant information on a voluntary basis where a firm may be important to one or both supervisors;
- **mandatory cooperation between host and home supervisors in respect of branches.** MiFID provides that “*the home and host competent authorities of the regulated market shall establish proportionate cooperation arrangements*” in situations where regulated markets are of substantial importance to the host;
- **mandatory coordination for home supervisors in respect of groups.** The FCD requires Member States to ensure that an authority is designated to coordinate between different supervisory authorities. It also introduces the concept of “key supervisors” – i.e. supervisors of other large entities (having more than 10 per cent of market share) within the group. It refers to subsidiaries, not branches, and is without prejudice to the legal responsibilities of supervisors of subsidiaries;
- **collegiate discussions.** The current draft of the proposed Capital Requirements Directive requires the home (or consolidating) supervisor to seek agreement with the host supervisor on group risk models and Advanced Measurement Approach approval. If agreement has not been reached after a six-month period the decision of the home (consolidating) supervisor will prevail;

- **mediation.** The Market Abuse Directive incorporates provisions for mediation between supervisory authorities;
- **delegation.** The Prospectus Directive allows for the delegation of responsibility for approving a prospectus from one supervisor to another (which might be used, for example, where the prospectus is more relevant to the latter or its experience is more appropriate); and

Chart 4.1: A taxonomy of different forms of cooperation between home and host supervisors.



Note: Using systemic risk as an example of impact criteria, then, as the degree of systemic risk an organisation poses to its host country increases, so the host supervisor will increasingly want to be involved in supervisory issues. For example, where a branch poses a high degree of systemic risk to the host country, so the host will increasingly desire a greater degree of interaction with the home supervisor.

- **powers of intervention in extreme circumstances for host supervisors in respect of branches.** In addition to the existing legal provisions for facilitating information-sharing and cooperation, there are additional emergency powers provisions which, if invoked, allow supervisory responsibility to transfer from the home to the host (e.g. for branches). For example, BCD⁵ provides a mechanism for the host supervisor to raise prudential concerns with the home supervisor, and if corrective action is not taken the host supervisor has a power to intervene. This is replicated in MiFID⁶ which provides for “*precautionary measures*” where, if the home supervisor does not act, the host can address the issue. The use of these provisions is envisaged only in the most extreme circumstances and only where the home state has not been fulfilling its obligations under EU law. Their effective use is dependent on the host supervisor being in possession

⁵ Article 22.

⁶ Article 62.

of adequate information to be able to determine when they should be invoked (highlighting the importance of good information exchange).

4.12 These examples demonstrate that there is considerable scope, within the current overarching legal framework, for supervision of cross-border financial institutions to:

- involve home and host supervisors together in carrying out **practical** tasks related to financial supervision; and
- introduce **marginal modifications** to these basic arrangements set out in paragraph 4.4 to enable home and host supervisors to meet their supervisory needs (particularly in respect of systemically important firms) in a way which minimises additional burdens for firms.

4.13 Moreover, in the day-to-day activities of financial supervisors, there are many further examples where practical cooperation takes place without specific legislative underpinning in EU legislation.

A POSSIBLE OVERARCHING FRAMEWORK

...using existing structures

4.14 The UK authorities believe that an effective framework for promoting and enhancing cooperation between supervisors will therefore need to combine the range of approaches to cross-border supervision enshrined in current EU legislation and the EU's new Lamfalussy arrangements for financial supervision to promote more effective cooperation between supervisors. An overarching framework would need to take as its building blocks:

- a set (or sets) of impact criteria;
- a set of models of cooperation;
- the provisions in existing EU directives; and
- the existing Lamfalussy structures (Levels 1, 2 and 3).

4.15 Putting these various elements together, an overarching framework for enhanced cooperation could be based on the following broad criteria:

- forms of enhanced cooperation need to take place within the framework of **EU law**; and
- they could be based on a set of **impact criteria** that while encompassing a range of areas, are primarily based on the systemic importance of the sector and institution in question. Such impact criteria could well differ across sectors, reflecting the different characteristics of market infrastructure, banks and insurance firms.

4.16 Greater scope for interaction between supervisors should not be allowed to mean greater supervisory burdens for firms. Indeed, quite the opposite – policymakers and authorities should continue to look for ways of reducing such burdens and increasing efficiency. This will continue to need further development. Effective coordination of regulatory programmes would go a long way to achieving this. In addition, it might be possible, in the longer term, to offer firms the chance to deal with

only one, rather than multiple, supervisors (for prudential issues, at least), leaving cooperation between supervisors to take place “behind the scenes”.

POSSIBLE IMPACT CRITERIA

4.17 To make the various cooperative supervisory arrangements operational, some agreed measures of the systemic importance of the regulated function carried out by a firm is needed. The task of fleshing these out might be remitted to the Level 3 committees although the basic framework ought to have some political endorsement (at Level 1 or 2).

4.18 Such measures would need to capture the main channels through which systemic risk might manifest itself, such as the scale and substitutability of the activities in a sector or by a firm.

4.19 Nevertheless, however good the cooperation arrangements become, supervisory authorities cannot assume there will be no failures and that insolvencies will never take place. As a result, appropriate arrangements – guarantee schemes – need to be in place to ensure that when this happens the interests of consumers are protected. Moreover, as increasing amounts of business is done cross-border, the necessity for such guarantee schemes to operate effectively on a cross-border basis becomes imperative. Different types of guarantee scheme are discussed in Box 4.1.

Box 4.1: Guarantee schemes

Guarantee schemes can help build consumer confidence and protect consumers against financial risks. There are three main guarantee schemes:

- **deposit guarantee schemes.** These are mandatory in all Member States. Responsibility for deposit guarantee schemes for banking is broadly aligned with that for prudential supervision: so for branches, it is a home responsibility, and for subsidiaries, a host one. Nevertheless, there is no convergence of the way schemes are funded, which could give rise to distributional issues;
- **investor compensation schemes.** Again, these are again mandatory within the EU. These arrangements operate on a home state basis so that firms from one EU Member State, or from the wider European Economic Area (EEA), which carry out activities in another Member State under an Investment Services Directive (ISD) passport, are not required to join the compensation scheme of the host Member State. However, such firms can obtain 'top up' cover from the host Member State's scheme if the level or scope of that cover is greater than the home Member State's scheme; and
- **insurance guarantee schemes.** There is, as yet, no EU-wide requirement to have insurance guarantee schemes, although the Commission is exploring the possibility of bringing forward a legislative proposal. The majority of EU Member States, including the UK, currently have some sort of scheme in operation.

However, the size, structure and complexity of markets is radically different in different parts of the EU, which in turn results in enormous differences in the cost and risk profile of such guarantee schemes. There are particularly large differences between old and new members of the EU. Therefore, attempting to create a single EU-wide guarantee scheme would inevitably result in inappropriate operation of the scheme in different Member States.

POSSIBLE APPROACHES FOR THE FUTURE

4.20 The UK authorities believe that these cases and other practical examples of cooperation demonstrate that:

- the current basic legal framework for the supervision of cross-border institutions (including branches and subsidiaries), as set out in paragraph 4.4, should remain the basis for financial supervision in the future;
- there is scope within the range of legislative approaches currently used within the EU to ensure that future legislation concerning financial supervision takes account both of the interests of firms and supervisory imperatives in a more integrated Single Market; and
- most importantly, the effective supervision of cross-border institutions will rely on choosing and delivering the most appropriate forms of cooperation between national financial supervisory authorities. The basis for such cooperation is increasingly likely to be specified in future EU legislation, but the most important challenge will be to make this work at the practical level whether or not it is dealt with specifically in law.

4.21 The UK authorities consider that this approach provides a powerful framework for addressing cross-border supervisory issues in the EU. Although the challenges in individual sectors will vary, the UK believes that the framework could be applied effectively across the banking, market infrastructure, insurance and securities sectors.

RESPONSIBILITIES OF HOME AND HOST SUPERVISORS: CONCLUSIONS

4.22 This chapter has described some of the complexities of setting the respective responsibilities of home and host supervisors and the manner in which they cooperate.

4.23 In summary, the UK authorities believe that:

- the **current legal responsibilities** of home and host supervisors should remain as set out in existing directives;
- the framework provided by **existing directives** should also form the basis for future EU legislation on the supervision of cross-border institutions (including branches and subsidiaries);
- there is scope within the **range of legislative approaches** currently used within the EU to ensure that future legislation concerning financial supervision can take account of the interests of firms, consumers and supervisors in a more integrated Single Market;
- the effective supervision of cross-border institutions will rely on choosing the most appropriate forms of **cooperation** between national financial supervisory authorities and making them work in practice. The choice of model of home-host cooperation should be based on key criteria, taking into account the potential systemic impacts of sectors and individual firms; and
- most important of all, financial supervisory authorities need to **work more closely together** within the current legislative framework to deliver effective cooperation at the practical level.

OVERVIEW

5.1 As described in Chapter 1, financial markets in Europe and across the world are becoming more integrated.

5.2 Financial institutions want more efficient supervisory arrangements, for the reasons set out in Chapter 2. Investors and financial supervisors want supervisory arrangements that can tackle cross-border risks effectively and efficiently. Market participants and supervisors appear to recognise the need for closer supervisory cooperation and convergence of practice to respond to market trends.

5.3 There is no single or simple way to achieve supervisory convergence. The issues are complex and the solutions are multiple and multi-faceted. As described in Chapter 4, realigning legal and institutional responsibilities for supervision would be hard to achieve in practice and, in any event, seem unlikely to meet the needs of market practitioners, supervisors and consumers. Rather, this paper sketches out five related challenges that need to be addressed to make progress on achieving convergence of supervisory practice and offers some proposals for how this can be achieved. **Such proposals do not require new EU legislation** but instead focus on practical solutions. Taken together, these challenges and proposals present an ambitious framework for action.

CHALLENGE 1: IMPLEMENTATION AND ENFORCEMENT

5.4 With the FSAP, the EU is moving closer to having more consistent rules for the financial markets in each Member State. It is now necessary to ensure that this step change in convergence is achieved. **So the first challenge is to ensure the effective, consistent and proportionate implementation and enforcement of EU financial services legislation and greater convergence of supervisory practice in all Member States.**

5.5 Practical mechanisms are needed to help achieve this, involving supervisors and the financial sector, building on many of the initiatives that have recently been started, such as transposition groups. The priority of tackling this challenge has been recognised by the Financial Services Committee and in the four expert group reports of May 2004.

CHALLENGE 2: COOPERATION

5.6 **The second challenge is to improve cooperation between supervisors.** There is plenty of scope within the existing legislative framework for more effective cooperation. Equally, it is possible for new EU legislation to make provision for more effective collaboration between supervisors while remaining consistent with the overarching framework set out in the current directives.

5.7 The Level 3 committees in particular provide an excellent opportunity for developing cooperation. Supervisors cannot hope to monitor cross-border business without better cooperation. Business increasingly – and rightly – expects a more coordinated approach from supervisors that are responsible for applying an increasingly convergent set of rules to the same institution.

5.8 Cooperation can take place in many different ways, as described in Chapter 4. Different models are likely to be appropriate for different circumstances, depending on the size and nature of the activities concerned, but include better sharing of information, consultation and joint working. It is clear that cooperation will become more important as markets become more integrated.

5.9 It will be important to choose the right models for cooperation in particular circumstances, taking into account the financial activity and the firm involved. The UK authorities propose that this choice should be guided by a series of impact criteria based primarily on the systemic importance of an institution to the home or host Member State.

5.10 Member States need to ensure that such a cooperative approach is facilitated and not inhibited by the remits and powers that supervisory authorities are given in national legislation.

5.11 More radical options for the legal basis of supervision, and in particular radical changes to the division of responsibilities between home and host supervisors, may not be feasible, but in any case do not appear to be necessary.

CHALLENGE 3: DATA

5.12 **The third, related, challenge is to ensure the supply and sharing of data to, and between financial supervisory authorities, is efficient and effective.** The availability and provision of data to multiple supervisory authorities are key problems, for supervisors and financial institutions.

5.13 There is good work under way, and the prospect of further developments in future. Market initiatives look like being the best way to tackle the challenge of improving the efficiency of data flows within the markets, between firms. Supervisors need to work together to define common data requirements for firms and reach agreement among themselves on adopting common formats or “languages”. They must also ensure that their own approaches do not hinder innovation and competition, especially in the flow of data between market participants. One goal for the future should be for firms to be able to supply data about their activities in one area (such as banking or securities trading) to only one supervisory authority

CHALLENGE 4: CRISIS MANAGEMENT

5.14 One of the biggest challenges for any financial supervisor is dealing with a potential or real crisis. Unless planned for, normal working arrangements tend to come under severe strain and collapse altogether in crises, just when decisions are needed most urgently and cooperation becomes critical. **So the fourth challenge is for supervisory authorities to work with central banks and finance ministries to maintain financial soundness and mitigate the risks of financial crises.**

5.15 This work, therefore, needs to be based on stronger connections and ultimately on deeper trust that can allow responses to be efficient and flexible. Practical mechanisms such as crisis management exercises are needed to ensure that preparations are robust, well tested, and embedded in MoUs. And ultimately in a crisis, supervisors need the powers to take decisions quickly and fairly, and to have joint teams on stand-by to deal with any institutions that might present cross-border risks. It will also be essential for arrangements to involve authorities from third countries, as markets become more integrated globally as well as in Europe.

CHALLENGE 5: TRUST

5.16 The fifth and biggest challenge is to continue to develop trust between market participants and supervisors, and between supervisors themselves. Supervisory authorities – and national governments – must have trust and confidence in each others’ judgments and actions. Trust is also needed between supervisory authorities and the participants in the financial markets (institutions, investors and consumers) so that decisions will be taken fairly and in a non-discriminatory manner.

5.17 The best ways to increase trust are to increase transparency (for example, of national rule-books), work more closely together and address any conflicts of interest.

5.18 Supervisory authorities need to be open to review by their peers, and must be able to justify their decisions to the markets and to their counterparts.

5.19 Where there are gaps in supervisors’ skills and experience, they need to be supported and to learn from best practice. Secondments and interchange between supervisory authorities, and between the authorities and the financial sector, will break down cultural barriers.

5.20 Trust between EU supervisors and those in third countries must also be increased, through continuing the improvements underway in dialogue with other jurisdictions and through international bodies.

5.21 Finally, trust is also more difficult to develop where supervisors have other, competing obligations and responsibilities: such potential conflicts need to be reviewed and removed if appropriate.

5.22 Tackling these issues will help improve trust and in turn facilitate the convergence of supervision that both the markets and financial supervisory authorities desire.

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