

# *An Alternative Design Framework for International Coordination of Banking and Financial Supervision*

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## **Abstract**

Europe is in search of an optimal organization that will enable the efficiency of the surveillance of the banking and financial services industry by reforming the European Banking and Financial System. The purpose of this paper is to analyse some of the important issues concerning the prudential supervision of banks and financial institutions in the European Union and to discuss related concerns about regulation both at the European and international levels. We suggest that prudential rules and institutional arrangements could be further harmonized between Member States to limit the frequency and extent of individual bank or financial institution failures as well as those of systemic crises. Our results underline that the harmonization of rules, procedures, and institutional infrastructures of Member States and the implementation of a new institutional organization of coordination both at European and international levels could engender an increase in the quality of information exchanges between all actors.

## **JEL Classification**

G01; G21; G28.

**Keywords**

Financial regulation, financial supervision, financial crises, European banking and financial system, Europe

**Öz**

Avrupa, bankacılık ve finansal sistemini reforme ederek, bankacılık ve finansal hizmetler endüstrisinin denetiminin etkinliğini sağlayacak optimum bir organizasyon arayışı içindedir. Bu makalenin amacı, Avrupa Birliği'ndeki bankaların ve finansal kuruluşların ihtiyati denetimi ile ilgili önemli konulardan bazılarını analiz etmek ve hem Avrupa düzeyinde hem de uluslararası düzeyde düzenlemeyle ilgili endişeleri tartışmaktır. Münferit bankaların veya finansal kurumların başarısızlıklarının yanı sıra sistemik krizlerin sıklığını ve kapsamını sınırlandırmak için, ihtiyati kuralların ve kurumsal düzenlemelerin üye devletler arasında daha uyumlu hale getirilmesini önermekteyiz. Sonuç olarak, üye devletlerin kurallarının, usullerinin ve kurumsal altyapılarının uyumlaştırılmasının ve hem Avrupa'da hem de uluslararası düzeyde koordinasyonun yeni bir kurumsal düzeninin uygulanmasının, tüm aktörler arasındaki bilgi alışverişinin kalitesinde bir artışa neden olabileceğini vurgulamaktayız.

**Anahtar Kelimeler**

Finansal düzenleme, finansal denetim, finansal krizler, Avrupa bankacılık ve finansal sistemi, Avrupa

## 1. Introduction

The institutional scale of prudential mechanisms is an old principle that dates from the 1930s, when the implementation of prudential mechanisms began. At that time, prudential mechanisms were envisaged, created, and built by the establishment. However, the transformation of economic policies and financial globalization led to the evolution of prudential systems through multilateral agreements. The major financial crises brutally emphasized the role of regulations and underlined the importance of prudential coordination mechanisms among supervisors at national and international levels.

The regulatory platform for the banking industry of the Eurozone gathers harmonized rules with the specific rules of countries. The harmonized part of the platform, which was mutually known, includes—since the adoption of The First Banking Coordination Directive in 1977—most of the basic prudential measures developed in national systems over the years.

Effectively, this progress, based on a first flood of banking directives, was developed during more than twenty years of European experience. This first stage allowed for the creation of common principles that previously announced the emergence of the doctrine of *the level playing field*—that is, the genesis of an economic space conforming to harmonious and identical conditions of competition among Member States. From this period, the main principle of prudential supervision started to bear upon the search for intensified cooperation among national supervisors. However, at first glance, this principle declares itself as an answer to the incapacity of the national banking and financial peculiarities and to the competitive gap among Member States.

The non-harmonized part of the platform includes national specificities that are completely diversified. This non-harmonized part includes organizational measures for the conduct of banking supervision, tools used by banking supervisors, provisions for bankruptcy and the restructuring of banks, and the definition and legal protection of financial instruments and contracts. Nevertheless, the concept of a regulated and harmonized market is of a very limited scope because of the absence of

full financial integration in the EU (Kozanoğlu, 2007, p. 14).

At the moment, multilateral cooperation in Europe almost closes its eyes on the dialectic of the European monetary integration as if the unification of the financial markets and the creation of the single currency ensued from ill-assorted ideas and from diverse reasonings: the adoption of the Maastricht Treaty in 1991 anticipated the establishment of the principle of recognition of supervision by the home country for banks having cross-border activities within the EU. Then, the Treaty on the Organization of the Banking Supervision resulted from the subjective and imperfect circumstances of the National Central Banks (NCBs) facing prudential supervision of their banking and financial activities. The supervisor's role is no longer played by the central bank; rather, it is performed by an independent authority in the seven out of 15 states of Europe. In eight other states, its impact is strong and solid. Therefore, the European System of Central Banks (ESCB) essentially consists of central banks nearly fully responsible for the supervision of banks. Yet, the eventuality of a centralization of the banking supervision within the ESCB, according to the creative texts and the statements of the treaty of ESCB, is not sure and clear. Such a task of central and important organs like the ESCB or the European Central Bank (ECB) is not emphasized by the Treaty of Maastricht or by the founding texts of the ESCB.

To maintain the monetary and financial stability of the Eurozone, in the article 105(5), the Treaty of Maastricht (1992) emphasizes the role of prudential supervision mechanisms. The article 25-1 relative to the Statutes of the ESCB points out, in a more formal way, the assistance and help of the ECB, the Council, the NCBs, and the European Commission. Also, the article 105(6) of the Treaty of Maastricht and the article 25-2 of the Treaty of ESCB permit a possibility for the transfer of several prudential tasks (except insurance companies), according to the decision of the Ecofin Council and that of the European Parliament.

Consequently, the prudential system of the banking and financial services of the EU continues to ensue essentially from the principle of subsidiarity: a geographical separation among national authorities stipulating that they are completely responsible for the prudential

supervision, and that they are proper authorities at the national level. This geographical separation of the prudential control of the banking and financial institutions within the EMU turns out as a succession of the integration of the banking and financial services market. Therefore, the dominant logic about prudential coordination among national supervisory authorities is completely based on the geographical cooperation among Member States of the EU.

Additionally, The Treaty of Maastricht concretized European complexity relative to this geographical separation and strengthened the jealous national traditions respected by the supervisory agencies and the NCBs about the role of “lender of last resort” (LOLR). The delegation of the role of LOLR was realized by the Treaty without the decision-making contribution of the ESCB and was based on the hypothesis that the financial crises occur in a specific state where the effects are locked and isolated because most of the assets and banking commitments are in touch with the residents of this state. As a result, in Europe, the institutional *status quo* escapes problems of cooperation between national supervisory authorities and gives to states a full responsibility for the decision of the socialization of losses (Kozanoğlu, 2007, p. 15).

Concerning the supervision of banks, the ECB has no direct responsibility to oversee banks and to establish banking stability, but it has a vital interest in the stability of the banking and financial services industry because the main objective of the ECB is price stability. Moreover, the establishment of European financial stability is completely dependent on the efficiency of the supervision mechanism and on the maintenance of monetary stability. Therefore, the national supervisors and the ECB need clear and precise knowledge of the situation regarding the Eurozone’s banking and financial services, and certainly of the situation related to its main actors.

Indeed, the consolidation of cooperation between supervisors is a particular and complicated subject that has several aspects. First, different types of risk engender various implications in banking and financial markets. The means of prevention and their position in the safety net differs inside these markets. Second, financial globalization

boosted the growth of many cross-border financial groups that require the expansion of coordination at the international level. In addition, diverse companies belonging to the same financial group are subjected to separate and individual prudential constraints. This is why there is a strong need for consolidation of cooperative connections among different supervisory authorities at national and international levels.

An intense and effective information exchange between national authorities and the ECB would limit the effects of moral hazard and would help maintain it in a homogeneous degree inside the EMU. In this respect, it is important to know how it could be possible to establish an effective prudential coordination mechanism that would limit the effects of moral hazard, which would generate a better information exchange between national supervisory authorities, banks, financial intermediaries, and the ECB; and which would create an adequate harmonization of rules and procedures.

In this context, after the establishment of the single currency and considering the problems and existing deficiencies in the supervision of the monetary and financial system, Europe is in search of an optimal organization that will enable the efficiency of the surveillance of the banking and financial services industry by reforming the European Banking and Financial System.

In Europe, a new prudential doctrine appears to be emerging since new debates and discussions have taken place following the global financial crisis in spite of the continuity and preservation of the logic of geographical separation in supervision structures. Although certain natural benchmark models are supplied to the Eurosystem by the countries that apply the approach of separation, such as the UK and Germany, new prudential actions such as recent propositions of the European Commission, supported by the European Council, the Lamfalussy Framework, and, in particular, the de Larosière Report, confirm a division of supervision structures in a decentralized system to reach an ultimate centralization of EU's regulatory framework and seem more susceptible to making coordination between the supervisors of banking and financial institutions more effective.

Considering the directives that ensue from the European authorities, the European Central Bank and the Bank of International Settlements, the purpose of this paper is to analyse some of the important issues concerning the prudential supervision of banks and financial institutions in the EU and the related issues of regulation, both at the European and international levels.

This paper argues that the current prudential supervision framework of banks and financial institutions in the EU is largely concerned with the shortcomings of the institutional design of current prudential policy that result from a tension between the highly decentralized prudential framework and the ongoing progress in financial integration. We suggest that prudential rules and institutional arrangements could be further harmonized between Member States to limit the frequency and extent of individual bank or financial institution failures as well as those of systemic bank crises for minimizing the externalities of systemic risk. This paper then reviews the legal and regulatory framework of banking and financial supervision in the EU to illustrate some of the strengths and weaknesses of the European approach and suggests a possible institutional design for all the jurisdictions by also taking into account the impact of recent international initiatives in the area of banking and financial supervision, including some new proposals of the G20 and Basel Committee on Banking Supervision, such as BASEL III.

Finally, our results underline that the harmonization of rules, procedures, and institutional infrastructures of Member States and the implementation of a new mode of institutional organization of coordination both at European and international levels could engender an increase in the quality of information exchanges between all actors. Furthermore, it would allow for a reduction of the moral hazard in prudential supervision, thereby improving forecasting and enabling better prevention of systematic risks and contagion. An important proposition that this paper provides is that Europe's new harmonized institutional regulatory design must be in rapport with a new institutional design that could be constructed through the harmonization of prudential rules between G20 countries, and that both institutional designs can

lead to the creation of a highly coordinated international supervision mechanism for the intensification of international financial stability.

This paper is organized as follows: Section 2 describes the decentralized system of the prudential supervision in Europe. Section 3 reviews the centralized system of the prudential supervision in Member States. Section 4 handles the Lamfalussy Roadmap. Section 5 specifies the key points (5.1) and, in particular, the contribution of the de Larosière Report on the European supervisory structure design and global repair (5.2). Section 6 deals with policy options and measures on the regulatory repair for the supervision of cross-border institutions. Section 7 reviews the Basel III accord, and, following the recommendations of the de Larosière Report, the G20, and the Basel Committee on Banking Supervision, this section proposes an institutional integration model to enhance cooperation and coordination between the EU and the G20 (at the global level). Section 8 concludes the paper.

## **2. Decentralized system of prudential supervision in Europe**

The current system of prudential coordination within the EMU is based on the principle of geographical separation. This principle concerns two inseparable and complementary pillars: the principle of mutual recognition among national supervisory authorities, and the reaffirmation of the principle of control by the home country. These two principles allow all banks to be overseen by one of the Member States, and to exercise their activities everywhere in the EU, thanks to common consent. The existence of subsidiaries and branches within the EU is subject to enhanced supervision and to the information exchange between national supervisors.

In the Eurozone, the legislative platform of the banking sector, although it is little common and much diversified, does not seem to include inconsistencies that risk hampering the pursuit of systematic responsibility. Taking into account its regulatory side, it can be considered to be a light system.

As the execution of banking supervision is a national task, according to the distinction of Padoa-Schioppa (1999, p. 301), it consists of two

types of functioning: “the supervisor of the Eurozone,” which is the cooperative system of national supervisors; and the “central banker of the Eurozone.” The supervisor of the Eurozone can be considered a rather particular entity that consists of national agencies working in three modes: “autonomous,” “bilateral,” and “multilateral.” The autonomous mode is the one in which the supervisor runs exclusively in the national context (even local). The bilateral mode involves cooperation between two agencies of supervision. It is used for the supervision of the same type of financial institutions, such as credit institutions, or supervision of various types of financial institutions when they have cross-border activities or establishments in foreign countries. The multilateral mode is the one in which a group of supervisors works collectively in uniquely strengthened roles.

The Committee of Banking Supervision is one of the essential forums for multilateral cooperation. It comprises representatives of the banking supervision authorities of the EU’s Member States, such as central banks or other separate bodies. The main functions of the Committee of Banking Supervision are, on one hand, the promotion of a unified information exchange between the Eurosystem and the national authorities of supervision; and, on the other hand, cooperation among the EU’s supervisory authorities. However, within the framework of the Committee of Banking Supervision, a multilateral mode of prudential coordination among EU’s banking supervisors is very limited.

The maintenance of the geographical separation can be practical only so much as the European financial services market is not completely harmonious and uniform in the regulatory, accounting, or competitive domains. So, the regulatory difficulties related to the geographical separation result from the differences between EU Member States. However, a much decentralized mode is, in reality, the most effective, because it allows for the use of information that cannot be far away from the market where credit institutions work (Padoa-Schioppa, 1999, p. 302).

In addition to the defects regarding the current logic of geographical separation explained above, there are also three main deficiencies

affecting the efficiency of the European prudential coordination mechanism because of its multilateral nature. These deficiencies are as follows (Couppey-Soubeyran & Sessin, 2001, p. 147):

- *“The supervision of cross-border operations,*
- *The management of a spreading systemic crisis in the Eurozone,*
- *The regulation of cross-border banking groups and financial conglomerates.”*

Although the harmonization of prudential principles entails an extension of cross-border operations, the supervision of cross-border operations was not simplified in the supervision made by the home country. As such, the double supervision by the home country and the host country brings a solution to the supervision of cross-border operations. However, the double supervision increases the level of inconveniences, such as the costs of prudential supervision, although it strengthens the links inside the financial safety net.

As already discussed, the evolution of cross-border activities and services, and the integration of the activities and the actors inside the EMU, increase the probability relative to the occurrence of the systemic risk, from where an additional obstacle results: By reason of the existing organizational heterogeneousness that entails a process of institutional and regulatory harmonization, the therapeutic mechanism establishing the final financial stage of the safety net is less boosted than the prudential mechanism. The instructions for capital adequacy, the legitimization of internal controls, and the reform of the Cooke ratio contribute to this process of harmonization and to the adaptation of prudential principles in decentralized levels.

In light of this discussion, it is possible to suggest that the decentralization of the prudential coordination mechanism among supervisory agencies at the international level demonstrated its efficiency, and that decentralization is the optimal solution. However, a large number of economists are for centralization in order to increase the efficiency of the current prudential mechanism in Europe<sup>1</sup>.

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<sup>1</sup> These economists are Prati, Schinasi, Freixas, Schoenmaker, Véron, De Larosière, Couppey-Soubeyran, etc.

### **3. Centralized system of prudential supervision at the national level**

Leaning on the concept of “the submission of the regulator to a dialectical progress” of Kane (1981, 1989), the regulation is limited to progress in a temporary process of “creative destruction.” In other words, the periodic and common controls are required to limit the inadequacy of the regulation. The adequacies of the regulator for the progress of the institutional limits lead to the improvement of its method.

The behaviour of the regulator may provoke an expansion of the instability and uncertainty that it has as an objective to avoid. Also, there are additional difficulties with respect to coordination among supervisory authorities driven by the separation and decentralization of prudential systems. At present, coordination problems among different supervisory authorities at the national level are as complex as the problems of prudential coordination at the international level. In light of these obstacles, a centralized prudential system at the national level would allow for the application of the same prudential device to all financial intermediaries by a unique and independent institution.

The restoration of this unique authority would allow for the internalizing of the external progress undergone by the institutional structures: “Neither the waves of specialization, nor those of despecialization or universalization of institutions would alter the structure of a centralized prudential device.” Thus, the achievement of greater financial stability would lead to the stability of the banking and financial systems in the EMU.

Emanating from the reform of the Bank of England and the FSA, the British prudential mechanism clearly enlightens this logic, and it can be considered a model. At the end of this improvement, the British FSA will become the most integrated authority in Europe because the supervision of all the banking and financial activities in the country are made by this independent institution. However, the main reason for the establishment of this authority results essentially from the costs related to the antecedent prudential mechanism, which urged the British authorities to shrink their prudential mechanism by creating a unique authority, and from the recognition of the institutional centralization’s

efficiency. In this model, diverse systems of supervision reflect the powers of a legal, separate, and independent entity.

The Scandinavian countries of the EU, such as Denmark, Sweden, and Finland; as well as Belgium, France, and Germany, are the Member States that adopted this model. However, in Europe, in a large number of its countries, the separation between the banking supervision and the supervision of insurance companies continues to exist entirely while their activities become more and more integrated. As such, it is possible to suggest that the adoption of the Investment Services Directive (ISD) can be considered a triggering mechanism of an institutional centralization process of prudential mechanisms. It constitutes “a European passport” for investment companies similar to that of credit institutions, and it establishes the principles of the institutional centralization process. This centralization contributes to the implementation of fair competition, answering to the *level playing field* principle with the result being “same activities, same rules.” The institutional centralization does not only consist of the equalization of activities. The main objective of this system also focuses on the construction of the base of a prudential and regulatory device that would generate greater stability and efficiency.

Nevertheless, Plihon (2000, p. 19) argues that the establishment of a central and unique agency eliminates the competition between supervisory authorities. Accordingly, Lannoo (1998, p. 12) proposes that strong competition could help increase the efficiency when various agencies work together and collectively.

Belgium, and the Scandinavian countries, showed identical peculiarities resulting from the extension of their respective regulatory commissions’ responsibility and of their autonomy. *Finanstilsynet* in Denmark is incorporated into the Ministry of Industry and oversees all banking and financial systems, such as credit institutions as well as financial markets and insurance companies at the same time. It is also the case for Sweden, where the supervision of all financial intermediaries (credit institutions, pension funds, and also insurance companies) is assigned to a central authority built on the FSA model.

The responsibilities of the Finnish FSA in financial markets started

to expand to all market participants from the end of the 1980s<sup>2</sup>. Also, in Belgium, the responsibilities of the Banking, Finance and Insurance Commission (CBFA), which are at the heart of the banking sector, were gradually increased. The enlargement of the supervisory responsibility of the Commission for the Supervision of the Financial Sector (CSSF) in Luxembourg included credit institutions, other experts of the financial sector, collective investment schemes, stock exchanges, and financial markets.

As a result, it can be considered that at the national level, this centralized model of the prudential coordination between credit institutions, other financial institutions, clearinghouses, pension funds, and insurance companies does not seem to be homogeneous between Member States.

The decentralization and subdivision of prudential mechanisms at the national level entail difficulties about the plurality of supervisory authorities by multiplying the problems of coordination. So, a centralized mechanism managed by a central and unique authority, at least at the national level, would allow limiting coordination problems at both *intra- and international* levels. However, conversely, a decrease in prudential coordination would also occur by creating a central authority, rather than keeping the plurality of authorities, as in the case of a large number of countries in Europe.

The reduction of the coordination problems at the national level would allow for a calming of the international debate by focusing it on key issues connected with European prudential harmonization. So, the effects would be really positive because this central national authority would certainly allow for improving the quality of the information exchange between Member States' supervisory authorities at the European level. In addition, this centralized system would be totally suited to the regulation of cross-border financial institutions.

These arguments lead one to think that the conditions for a prudential coordination mechanism's greater efficiency could be achieved, thanks to a centralized prudential device at the national level rather than in

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2 Except the insurance companies.

the current situation, which is based on institutional decentralization and subdivision, which remains in the majority of Member States. This proposition can be presented and considered as a reorganization of current national prudential mechanisms (Kozanoğlu, 2007, 21).

#### **4. The Lamfalussy roadmap**

The Lamfalussy framework is reinforced by a roadmap, adopted by the ECOFIN Council in December 2007, which aims to improve the functioning and operation of the current EU supervisory framework—more precisely, the functioning of the Committees of Supervisors (EC, 2007). Earlier evaluations of the Lamfalussy framework—by different EU institutions and forums—are considered by the Council in order to formulate its assessment. As the Lamfalussy framework is strongly supported by stakeholders, the Council decided to establish additional improvements at all levels of the framework without making a change to the inter-institutional balance between the European Parliament, the Council, and the Commission. As a result, the Ecofin Council's (as cited in Lawson, Barnes, & Sollie, 2009, p. 21) recommendations were about: "*a) the arrangements for regulation (Levels 1 and 2 of the Lamfalussy framework); and b) the institutional setting of the Level 3 committees.*"

Concerning the legislative level of the Lamfalussy framework (Level 1), recommendations about taking some limiting measures for the use of national options and discretion in EU directives and the implementation of legislation have been endorsed. In addition, the importance of establishing realistic transposition and implementation deadlines for Level 2 measures is also underlined by the Council. At last, open and transparent consultations with attracted stakeholders were to be supported.

Several suggestions, especially with respect to improvements to accountability and decision-making, have been made in order to enhance the Level 3 committees of the Lamfalussy framework, which are in charge of the information exchange, and the cooperation and convergence of supervisory practices:

— To enhance the political accountability of the committees, national supervisors should orient their work toward supervisory convergence and cooperation, which will let financial supervisory authorities take into account financial stability concerns in other Member States.

— To reinforce the decision-making processes of the committees, the introduction of qualified majority voting in their charters has been suggested with the obligation for those who do not disclose their decision.

— To clarify the role of the Level 3 committees and to enhance their work, the commission decided to make a revision to the Commission Decisions creating the three Committees of supervisors that are assigned clear-cut tasks such as mediation, planning recommendations, and guidelines; and a clear role to improve the analysis and responsiveness to risks to the EU financial system's stability.

## **5. The institutional design proposed by de Larosière**

This section handles the key points (5.1), and in particular, the contribution of the de Larosière Report on the European supervisory structure design and global repair (5.2).

### **5.1. Key points of the de Larosière report**

Although the de Larosière Report (2009) is mainly focused on EU regulatory supervision, it does include global features of the new reforms it introduces. The report indicates its posture in the global financial crisis, but it especially concentrates on financial stability oversight and supervisory repair, which constitutes its core elements and its strongest parts for various reasons: (i) this subject is not handled in details in other reports; (ii) the De Larosière report underlines the importance of early warning systems that should be revised; and last, (iii) the report provides a model of organization, or in other words, an institutional design of supervision of different financial functions by establishing a systemic risk regulator that will include all functions.

As regards the reasons for the global financial crisis, the report focuses on some points such as abundant liquidity as a result of the loose monetary policy in the US and the accumulation of large

global imbalances, failure of the governance of financial institutions, ineffectiveness, and rating agencies' modeling failures, etc. Concerning the regulatory reasons, the report touches on the issues of the malfunctioning of current capital requirements and the lack of any denoting global coordination mechanism among international agencies such as the IMF, the Financial Stability Forum (FSF), and G20, etc.

The report also points out the under-priced government guarantees, the opacity of securitization structures and credit derivatives, the gambling of Basel Capital Requirements, and the abnormal incentives of bankers. It also proposes the following solutions to current deficiencies that distinguish the de Larosière Report from other reports: prefunding of deposit insurance funds, which is lacking in many European countries, larger transparency for the shadow banking sector, a multiyear setting of bonus standards, greater responsibilities for chief risk officers in company governance, and the standardization of derivative contracts with centralized clearing.

Anyway, the report does not directly discuss the too-big-to-fail problem or the quantification and/or penalization of systemic costs generated by the growth and risk-taking behavior of large and complex financial institutions. Furthermore, the weakness of European banks in terms of overall capitalization compared with US banks is also not handled in detail.

## **5.2. European supervisory structure design and global repair proposed by the de Larosière Report**

The recommendations of the de Larosière Report endorsed a clear and well-designed three-tiered structural approach<sup>3</sup>:

1. The establishment of the European Systemic Risk Board (ESRB) as a systemic regulator at the “top,” a new body responsible for the macro prudential supervision of the EU financial system.
2. The creation of the European System of Financial Supervisors

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3 The legislative proposals have been agreed to by the EU Member States, and they have also been approved by the European Parliament.

(ESFS), as practical regulators in the “middle,” including existing national supervisory authorities and the establishment of three new European Supervisory agencies such as the European Banking Authority (EBA), the European Insurance Authority (EIA), and the European Securities Authority (ESA) for related functions. Indeed, the establishment of these three agencies can be considered to be a result of the transformation of the three existing Level 3 committees.

3. At the “bottom,” national versions of the three practical regulators will rank.

The main task of the regulators in the middle and the bottom is to deal with each other, while that of national regulators is to coordinate daily supervision. The task of the European regulators is the coordination of overall supervision, macro-prudential supervision, and crisis-resolution actions. Last, the European Systemic Risk Board is in charge of the decision on the overall macro-prudential policy, as well as the use of risk warnings, which are considered as inputs to EU supervisors in the “middle,” and the Board gives them guidance built on comparisons across Member States.

Following the recommendations of the de Larosière report, it is possible to consider that the most important point is the coordination rather than centralization of all supervisory activities in one establishment. The report is original for three reasons:

- (i)* First, it proposes the creation of a supreme regulator at the top of the supervisory hierarchy, with a systemic outlook and larger responsibilities than other institutions.
- (ii)* Second, in fact, the de Larosière Report proposes a uniform decentralization at the national level in order to achieve an ultimate centralization of the prudential supervision mechanism at the European level.
- (iii)* Finally, the report can be seen as an important contribution to the global financial architecture with its recommendations for EU regulatory and supervisory reform and global coordination.

The report proposes a time frame of 2009–2012 to achieve the complete establishment of this institutional design.

## 6. Regulatory repair for the supervision of cross-border institutions

In order to limit the frequency and extent of individual bank or financial institution failures, as well as those of systemic bank crises, some policy options and several functional measures can be described as follows: (i) the strengthening of cooperation between home and host countries, (ii) the assignment of a lead supervisor for prudential supervision of cross-border financial groups, and (iii) the creation of a central agency that works in tandem with national supervisors (Schoenmaker & Oosterloo, 2007, p. 286).

- (i) *The strengthening of cooperation between home and host countries*: In the current system, the responsibility of the home country includes a bank or a financial group and its EU-wide branch network. The home country is also the consolidated supervisor. The host country has responsibility for a bank's or a financial group's EU subsidiaries and checks the stability of its financial system. Consequently, there should be cooperation between home and host countries for better financial supervision and greater stability. The de Larosière Report puts forth the establishment of global "colleges of supervisors" for the supervision of cross-border financial institutions.
- (ii) *The assignment of a lead supervisor for prudential supervision of cross-border financial groups*: This is to say that EU-wide operations, including both branches and subsidiaries, should be under the full responsibility of the home country authority of a pan-European financial group.
- (iii) *The creation of a central agency that works in cooperation with national supervisors*: It can be seen as a form of the European System of Financial Supervisors, including two different and fundamental forms: First, the creation of a pan-European central agency for the supervision of cross-border financial institutions with full responsibility for the EU-wide operations of pan-European financial institutions, including both branches and subsidiaries. Second, the consolidated supervisor should be responsible for the day-to-day supervision of cross-border financial groups.

In addition to these policy options, the introduction of home country supervision without implying the supervisory duplication by host countries, entailing different requirements or reporting forms, would help reduce the burden on European financial institutions, enhance cross-border enlargement in Europe, and encourage their competitive position vis-à-vis their counterparts in the US.

## **7. Enhancing cooperation and coordination between the EU and the G20**

Following the recommendations of the de Larosière Report (2009), the European Systemic Risk Board, which is considered to be the systemic risk regulator, is also supposed to play an important global role regarding the harmonization of various national regulations such as the Deposit Guarantee Schemes and their prefunding, the application of capital requirements, and the quality of supervision standards. The assessment and approval of any national exceptions are carefully performed by the Board.

The report proposes that all international relevant bodies such as the BIS, the FSF, and the IMF should be informed about macro-prudential risks that provoke a global dysfunction of monetary and financial systems. As the de Larosière Report emphasizes the importance of the coordination at both European and global levels, this proposed model of a central bank-based systemic risk regulator can coordinate international regulation at a global forum.

According to the report, the FSF would be the principal coordinating institution at the international level with the help of the BIS in establishing international standards, and with the IMF's assistance on early warning systems such as its Financial Sector Assessment Programme and on the improvement of a global early warning system for financial stability built on a "global risk map and credit register." Additionally, the report puts forth an adequate "tax" on aberrant jurisdictions involving activities to be subject to higher capital requirements. At large, the report underlines the important role of the EU, the IMF, and other international forums for the enhancement of global prudential coordination.

In addition to these propositions of the de Larosière Report, the approval of the Basel III accord on financial regulations during the G20 meetings in November 2010 in Seoul generated a strong recognition about worldwide harmonization of financial rules. The Basel III accord results from the tightening of the earlier requirements of the Basel Committee on Banking Supervision and aims to fill the gaps of Basel II and heal the dysfunctions it generated. The Basel III focuses more precisely on the prevention of liquidity risk but also introduces a macro-prudential regulatory aspect by distinguishing itself from both Basel I and II. Its most important requirements are as follows: (i) the minimum common equity requirement increases from 2% to 4, 5%, and (ii) in order to bear future periods of stress, banks are required to hold a capital conservation buffer of 2, 5%. Thus, common equity requirements will jump to 7%.

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The Basel III accord generates a submission of global finance into a single rulebook by bringing minimum standards, despite the evident differences in regulatory, supervisory, and legal systems across countries. To achieve the ultimate harmonization of global finance, thanks to the application of Basel III standards as well as that of the harmonization of global financial regulation, requires enhanced coordination and cooperation among the EU, the G20, and all international relevant bodies such as the IMF, the BIS, and the FSF, as already discussed.

For this purpose, in as much as Larosière's institutional design is approved and is under construction within the EU, other members of the G20 should also be required to build their institutional design for the worldwide harmonization of financial rules. In this respect, two suggestions can be put forth: First, a multilateral financial charter can be designed across G20 national authorities: this international financial charter, built on commonly agreed principles and standards, would be responsible for the setup of Memorandums of Understandings as regards the information exchange, cooperation, and coordination, an important role that can be actually played by the International Organisation of Securities Commissions (IOSCO), which already has adequate rules to impede discretionary behaviours of its members and offers a sufficient

organizational structure (Spaventa, 2009). Second, a more rigid approach based on a World Trade Organization (WTO) design can be advanced. This WTO-style institution can be seen as the protector of a common rulebook built on compulsory requirements, negotiated by its members, with a serious penalization of aberrant jurisdictions. The first model could progressively transform into the second as the example of the transition from GATT to WTO (Spaventa, 2009).

In this point, our proposition bears upon the fact that this institutional model that could be built within the members of G20—except the EU—can be integrated or merged with de Larosière’s institutional design. The merger of these two different institutional designs can lead to the worldwide harmonization of overall financial and prudential rules by generating a sharp increase of coordination and cooperation at the global level.

Nevertheless, the integration of both the G20’s and de Larosière’s institutional designs does not lead to a proposal of one global financial regulator at the global level. Such a suggestion seems impossible because of the lack of a present common rulebook and of the differences between regulatory, supervisory, and legal systems across countries.

## **8. Conclusion**

In order to limit the frequency and extent of individual bank or financial institution failures as well as those of systemic bank crises; and to limit the externalities of systemic risk, prudential rules and institutional arrangements should be further harmonized at both the European and international levels. It is clear and evident that there is a strong need for an urgent and adequate harmonization of financial and prudential rules, procedures, and institutional infrastructures and for the establishment of a new model of institutional organization of coordination at both the European and international levels, which could generate an increase in the quality of information exchanges among all actors. Furthermore, it would allow for a reduction of the impact of moral hazard in prudential supervision, developing forecasting, and it would enable better prevention of systematic risks and contagion.

In practice, the current system of prudential supervision in Europe is built on a decentralized structure at the European level, while there is a strong tendency toward centralization at the national level. However, the endorsement of the de Larosière Report by European authorities brought about a theoretical basis for the establishment of an ultimate centralization at the European level, maintaining a uniform decentralization structure at the national level.

The de Larosière Report is an important contribution to future global financial architecture because the report underlines the importance of global coordination, including all relevant international bodies such as the IMF, the BIS, and the FSF. Additionally, the endorsement of the Basel III accord by the G20 highlights the strong intention for the submission of global finance into a single rulebook in order to achieve worldwide harmonization of financial rules. Herein, it is possible to suggest that the Basel III accord contributes to worldwide micro prudential harmonization, while the de Larosière Report brings insight about a European-based model for worldwide macro prudential harmonization.

An important proposition that this paper provides is that Europe's new harmonized institutional regulatory design must be in rapport with a new institutional design that could be constructed through the harmonization of prudential rules between G20 countries. and that both institutional designs can lead to the creation of a highly coordinated international supervision mechanism for the intensification of international financial stability. In this respect, a multilateral/international financial charter can be designed across G20 national authorities: This international financial charter would be responsible for the establishment of Memorandums of Understandings as regards the information exchange, cooperation, and coordination, an important role that can be actually played by the International Organisation of Securities Commissions (IOSCO), which already has adequate rules to prevent discretionary behaviors of its members and offers a well-designed organizational structure. In addition, a more rigid approach, based on a World Trade Organization (WTO) design, as the safeguard

of a common rulebook built on compulsory requirements with a serious penalization of aberrant jurisdictions, can be put forth. The first model can gradually change into the second model, as provided by the example of the transition from GATT to WTO.

Herein, our proposition touches upon the fact that this institutional model that could be built within the G20—except the EU—can be merged with de Larosière’s institutional design. The merger of these two different institutional designs can lead to the worldwide harmonization of overall financial and prudential rules by generating a sharp increase in coordination and cooperation at the global level and to the creation of a highly coordinated international supervision mechanism for the strengthening of international financial stability.

However, the integration of both G20’s and de Larosière’s institutional designs does not lead to a proposal of one global financial regulator at the global level. Such a suggestion seems impossible because of the lack of a present common rulebook and the differences between regulatory, supervisory, and legal systems across countries.

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