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Financial Supervision in the EU:
Is There Convergence in the National Architectures?

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Abstract

Against the background of the debate on the advisability of further centralizing prudential supervision in the EU this paper develops a study of applied institutional economics, analyzing the financial supervisory architecture of each of the 27 EU countries and assesses their degree of institutional convergence. The paper investigate whether the recent wave of reforms are leading to a convergence of the national architectures.

JEL CLASSIFICATION: G28, G38, E58.

KEY WORDS. FINANCIAL SUPERVISION, CENTRAL BANKING, CONVERGENCE, EUROPEAN UNION

[1] The views expressed here are those of the authors and do not necessarily represent those of te Banco de España or those of the IMF or IMF policy.

1. Introduction

The achievement of an integrated financial market has been a long-term objective of the European Union (EU). Against this background, there is a considerable debate on the degree of coordination of supervision . However, the debate remained dominated by a divergences in academic and policy circles between, on the one hand, light forms of coordination among national supervisors, and on the other, more centralized approaches. [2]

Policy makers´ recommendations for intensified coordination among supervisors and harmonization of their regulatory frameworks have specific implications for the EU. As of end of 2007, there were 46 banking groups with holdings of almost 70% of total banking assets in the EU. These cross-border banks operate in a multi-jurisdictional environment and do need to interact with multiple national supervisors. Against this background of increasing financial integration, there is a growing need to (re)assess the efficiency and effectiveness of any framework for banking regulation and supervision.

This paper is motivated by the finding that in the debate about supervisory coordination/centralization in the EU, thus far little attention has been paid to the convergence of supervisory architectures in member countries. The economic profession has mainly focused on the need to develop common regulatory frameworks (Nieto and Peñalosa, 2004, Lastra, 2006) and integrated financial oversight (Prati and Schinasi,1999; Goodhart, 2000; Holthausen and Ronde, 2005; Mayes, Nieto and Wall, 2008 among others)., This bias towards one aspect of supervisory coordination seems unjustified because other aspects may have an impact on the efficiency and effectiveness of any future European supervisory structure—whether it is a centralized or a decentralized one—and therefore deserve proper attention. The paper claims that any reform of the supervisory structure at the European level should benefit from the recent and current trends in countries' revealed preferences with respect to the institutional architecture.

To stimulate to this debate, this paper reviews current trends in reforms of the supervisory architecture in EU countries. While there is no such thing as an optimal supervisory structure, this review will nonetheless help us in identifying common preferences among the 27 EU countries (EU 27) that could be exploited in reforms at the European level. More importantly, it will allow us to analyze the implications of different structures for the governance of supervision at the EU level.

It is outside the scope of this paper to express a preference between these two options—or any other option. The aim is simply to discuss implications in terms of national architectures [3]

The paper is organized as follows in addition to this introduction. The second section presents an assessment of the state of convergence of the financial supervision architectures of the EU 27 countries. In line with the suggestions of the new research in the field, we analyze both the overall architecture of supervision and the role of the central bank therein. The third section concludes.

[2] See Fonteyne and Van der Vossen (2007) for an overview.

[3] Other proposals are circulating as well. See for instance Wirtschaftswoche (2009) where ECB vice-president Papademos suggests that the ECB be in charge of the supervision of the large banks with cross-border operations. The goverance implications of this option are fairly similar to those discussed for the ESFS case as will be demonstrated in later sections.

2. Convergence in Supervisory Architectures

The architectures of financial supervision has been going through a deep evolution on all fronts worldwide and the EU has not been an exception. Only 15 years ago, the issue of financial supervisory architecture was considered irrelevant. The fact that only banking systems were subject to robust supervision made several of the current organizational questions meaningless. In such context, the supervisory design was either considered deterministic (i.e., an exogenous variable), or accidental (i.e., a completely random variable).[4] Since then, financial market development, resulting in the growing importance of insurance, securities and pension fund sectors, has made supervision of a growing number of nonbank financial intermediaries, as well as the investor protection dimension of supervision, highly relevant.

As a result of these changes, financial supervisory architectures are now less uniform than in the past. In some countries the architecture still reflects the classic sectoral model, with separate supervisors for banking, securities and insurance (e.g. France, Spain and Italy).[5] This model dominated until the end of the '90s (Figure 1A, sectoral model in yellow), However, an increasing number of countries have shown a trend towards consolidation of the supervisory responsibilities (Figure 1B), which in several countries has resulted in the establishment of unified supervisors (e.g. UK and Germany) (dark green in the Figure 1B), that are different from the national central banks, while in few cases (e.g. Czech Republic, Ireland and Slovakia) (light green in the same Figure) the central bank is the unified supervisor. Furthermore Figure 1B shows also that one country – the Netherlands – adopted the so called objectives-based (peaks) model (grey in the figure).

The dynamic character of these reforms is highlighted by the fact that the present financial crisis is leading to a reassessment of the recent reforms (e.g. the debate in the United Kingdom following the Northern Rock debacle as well as the current discussion of the effectiveness of the supervisory architecture in Germany and Austria that has already completed its new reform at the time of writing), or has opened the debate in those countries that did not participate in the previous round of reforms (e.g. the United States).

The model of supervisory architecture and its degree of consolidation are two distinctive dimensions of the reform, although they can be correlated. In fact the same model of financial supervision can be designed with different degrees of supervisory consolidation. The single supervisory model, where the supervision of banking, securities and insurance markets is completely integrated, is based on just one control authority; but some powers (i.e. information gathering on the condition of financial intermediaries) can be shared with other authorities (typically the central bank). In the (classic) specialized (sectoral) model, with separate supervisors for banks, securities and insurance, at least three separate supervisors are established and more than one agency can supervise the same sector (as is the case in the US). The objectives-based

[4] For an historical perspective, see the discussions in Goodhart (2007) and Capie (2007).

[5] Political authorities in Italy and Spain have recently expressed their intention to reorganize their supervisory architectures In Italy, the Parliament discussed in 2005 the "hybrid" supervisory institutional setting, introduced a marginal reform of the antitrust responsibilities, reduced central bank involvement in supervision and shortened the Governor's term of office. In Spain, the government has announced its intention to reform the architecture of financial supervision separating financial stability and business conduct supervision in order to build an objectives-based model (see below in the text).

model, has one authority responsible for each objective of financial regulation (financial stability and business conduct). However, some countries have identified more than two goals of supervision. As such, Australia has developed a "four peaks model": The Australian Securities and Investments Commission (ASIC) promotes the fairness in the conduct of business, the Australian Prudential Regulation Authority (APRA) is responsible for micro financial stability (individual institutions) , the Reserve Bank cares about macro stability, while the Australian Competition and Consumer Commission is in charge of antitrust powers and responsibilities.

For the purposes of this study, we concentrate on the degree of consolidation in the EU 27. How can the degree of consolidation of financial supervision be measured? This is where the financial supervision unification index (FSU Index) developed in Masciandaro 2004, 2005 and 2006 comes in (description in Table 1). This index was created through an analysis of which and how many authorities are empowered to supervise the three traditional sectors of financial activity: banking, securities markets and insurance.[6]

To transform the qualitative information into quantitative indicators, a numerical value has been assigned to each type of regime, in order to highlight the number of the agencies involved. The rationale by which the values are assigned simply considers the concept of unification of supervisory powers: the greater the unification, the higher the index value.[7] Therefore for each European country we have the level of financial supervision unification.

Figure 2 shows a polarized distribution of the countries according to the FSU Index. On the one hand some EU countries (9)[8] show the lowest level of consolidation of supervision (Index equal to 1). On the other, some other EU countries (11)[9] have established a unified supervision (8 outside the central bank, 3inside the central bank) and show the highest level of supervision consolidation (Index equal to 7).

Furthermore, these different architectures are compatible with different levels of central bank involvement. Masciandaro (2006) uses the index of the central bank's involvement in financial supervision (Central Bank as Financial Authority Index -CBFA- described in Table 1). Figure 3 shows the frequency distribution of the CBFA Index. Again a polarization holds: In the majority of countries in the EU-27 (13) the central bank is not the main bank supervisor (Index equal to 1), while just in three countries (Czech

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[6]Sources: for all countries, official documents and websites of the central banks and the other financial authorities. The information is updated through 2006. See Table 1.

[7] There are five qualitative characteristics of supervisory regimes that we decided not to consider in constructing this index. Firstly, we did not consider the legal nature – public or private – of the supervisory agencies nor their relationship to the political system (degree of independence, level of accountability). Secondly, we excluded from this analysis the authority in charge of competition and market regulation. Since such an agency exists in all EU 27 countries, it was left out for the purposes of this analysis. We also did not include the agency in charge of the management of the deposit insurance schemes. In general, we consider only the three traditional sectors (banking, securities and insurance markets) that have been the subject of supervision. Finally, the financial authorities may perform different functions in the regulatory as well as in the supervisory area. However, at this first stage of the institutional analysis, we prefer to consider only the number of the agencies involved in the supervisory activities.

[8] Bulgaria, Cyprus, France, Greece, Lithuania, Poland, Romania, Slovenia, Spain .

[9] Belgium, Czech Republic, Denmark, Estonia, Hungary, Ireland, Latvia, Malta, Slovak Republic, Sweden, UK.

Republic, Ireland and Slovakia) the central bank is monopolistic in the overall financial supervision (Index equal to 4).

Considering both indices jointly for the EU 27 countries (Figure 4), the analysis shows that also the two most frequent regimes are polarised: on the one hand, Unified Supervisor regime (8 countries[10] in red) ; on the other, Central Dominated Multiple Supervisors regime (7 countries[11] in yellow) . The Figure seems to depict a trade off in the EU contest between supervision unification and central bank involvement, with three outliers (Czech Republic, Ireland and Slovakia in green).

3 . Conclusion

The landscape of national architectures of financial supervision in the EU is in line with the findings of the recent literature: the national choices on how many agencies should be involved in supervision seem to be so far closely correlated with the existing institutional position of the central bank. In general, the degree of supervisory unification seems to be inversely related with the central bank's involvement in supervision. The trade-off – and the related, so called central bank fragmentation effect - was confirmed first using a cross-country analysis of the reforms in the supervisory regimes (Masciandaro 2004, 2005 and 2006) and analyzing the economics of the central bank fragmentation effect (Masciandaro 2007 and 2008, Masciandaro and Quintyn 2008, Dalla Pellegrina and Masciandaro 2008). From a political economy point of view, the central bank fragmentation effect can be explained as a peculiar case of path dependence effect: the incumbent policymaker, in choosing the level of financial supervision consolidation, is influenced by the characteristics that already exist in terms of the central bank position. The policymaker's choices are viewed as a sequential process in which the institutional position of the central bank matters.

However, whatever the explanation of the supervisory architecture is, it is evident that the degree of convergence among the EU countries is low. Furthermore, it has been claimed that no "superior" model of supervision exists (Schoenmaker 2003, Quintyn et al., 2007, among others). Different contributions (Abrams and Taylor, 2002; Arnone and Gambini, 2007; Fleming, Lewellyn and Carmichael, 2004; Cihak and Podpiera, 2007a, and 2007b) claim that there are no strong theoretical arguments in favour of any particular architecture of financial supervision, given that it is possible to provide advantages and disadvantages of each model.

Even though there is no best practice with respect to the supervisory architecture, the trends in the EU nonetheless could have some policy implications. The existence of a polarized world in the field of the supervisory architectures is likely to produce competition between the two models and therefore the convergence process among countries will be more difficult, as well as the potential political agreement on centralization, given the absence of a common benchmark.

Moreover, there could be interaction between the degree of consolidation at the national level and the way European integration will proceed. A few examples may clarify the nature of this interaction. If a "European mandate" (Hardy, 2009) is first sought for banking supervision, then countries that have an integrated supervisor will either have to modify the mandate for their bank supervisors alone (and probably

[10] Belgium, Denmark, Estonia, Hungary, Latvia, Malta, Sweden, UK.

[11] Bulgaria, Cyprus, Czech Republic, Greece, Lithuania, Romania, Slovenia.

harmonize the objectives with the European objectives), or for all the sectors. National authorities may or may not like this approach. This could potentially have a different impact on the national supervisors, depending on whether they have sector-specific architectures or integrated architectures.

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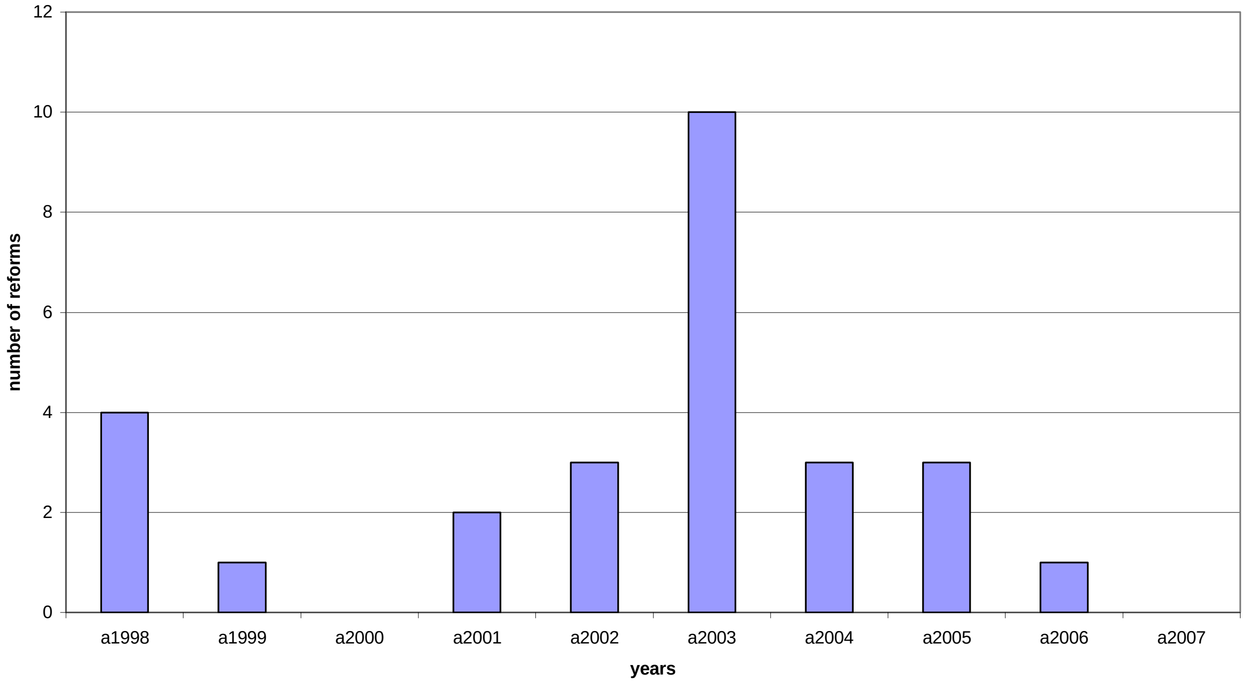
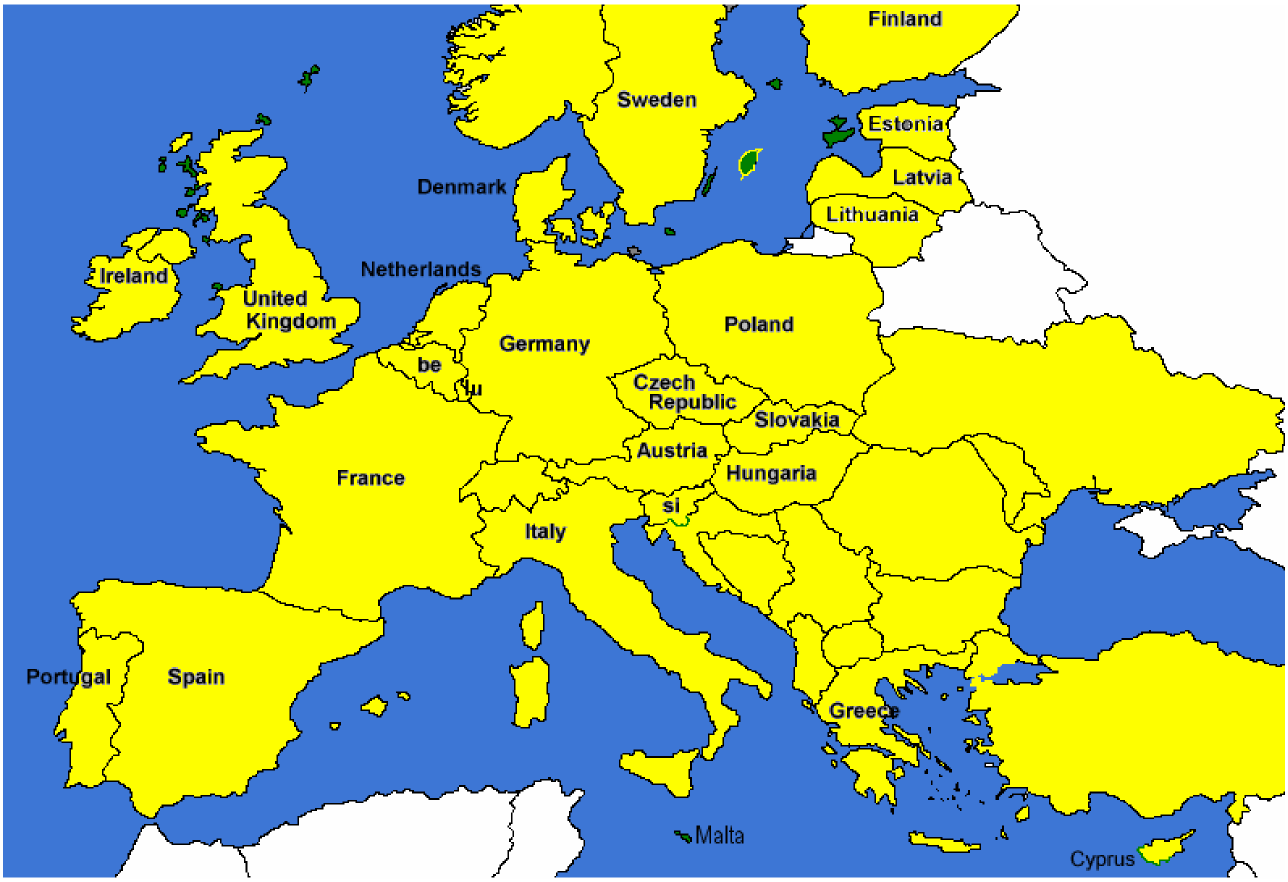
5. Tables and Figures

Figure 1 Financial Supervisory Regimes: number of reforms per year (1998-2008)

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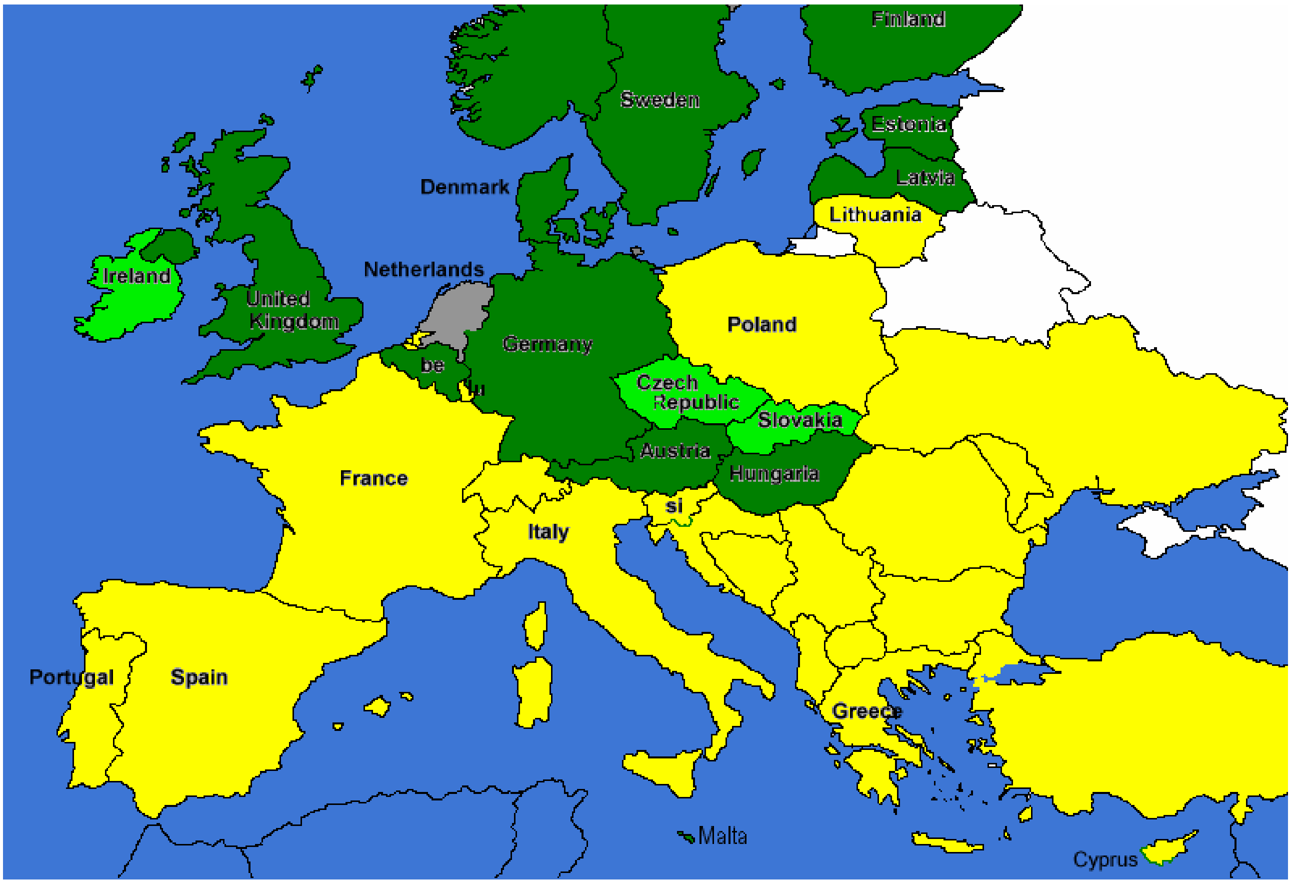
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Figure 2 FSU Index distribution

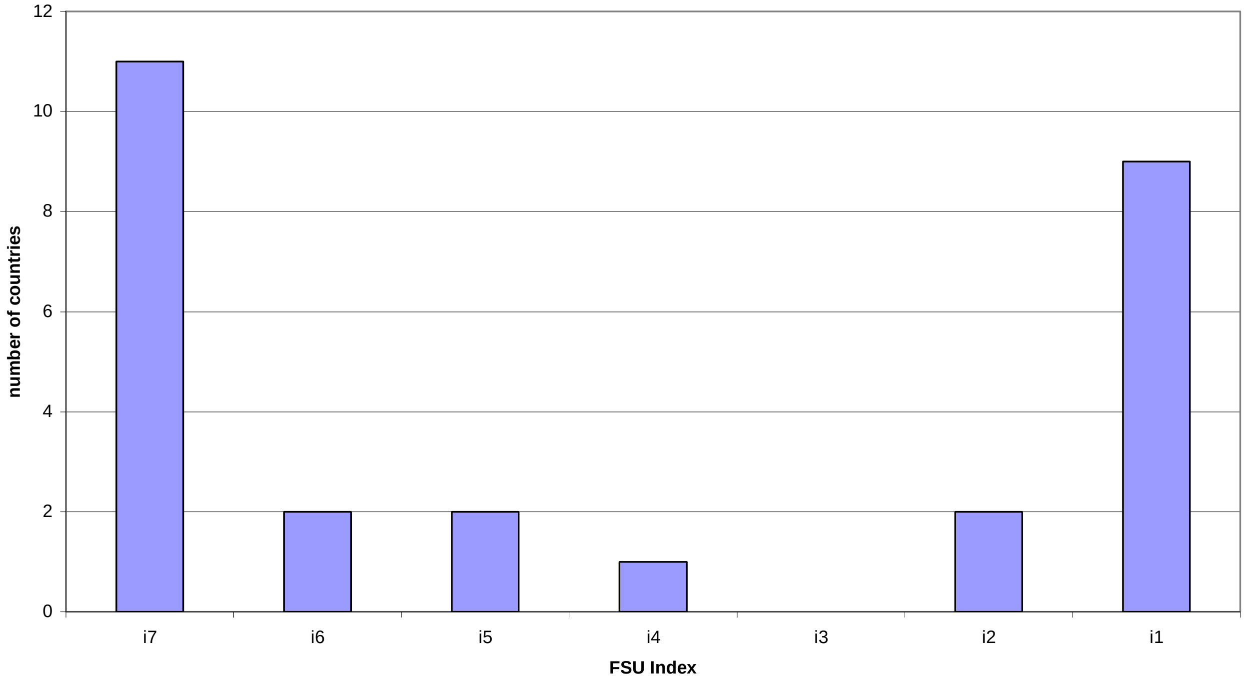


Figure 3 CBFA Index distribution

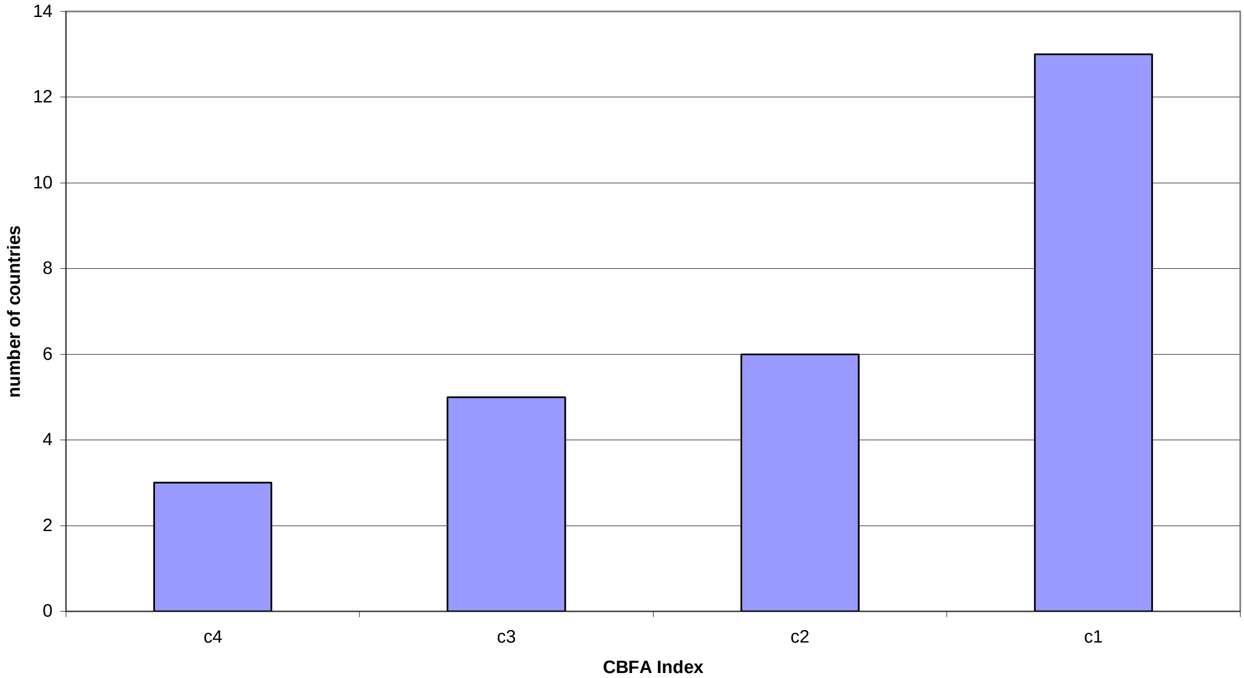
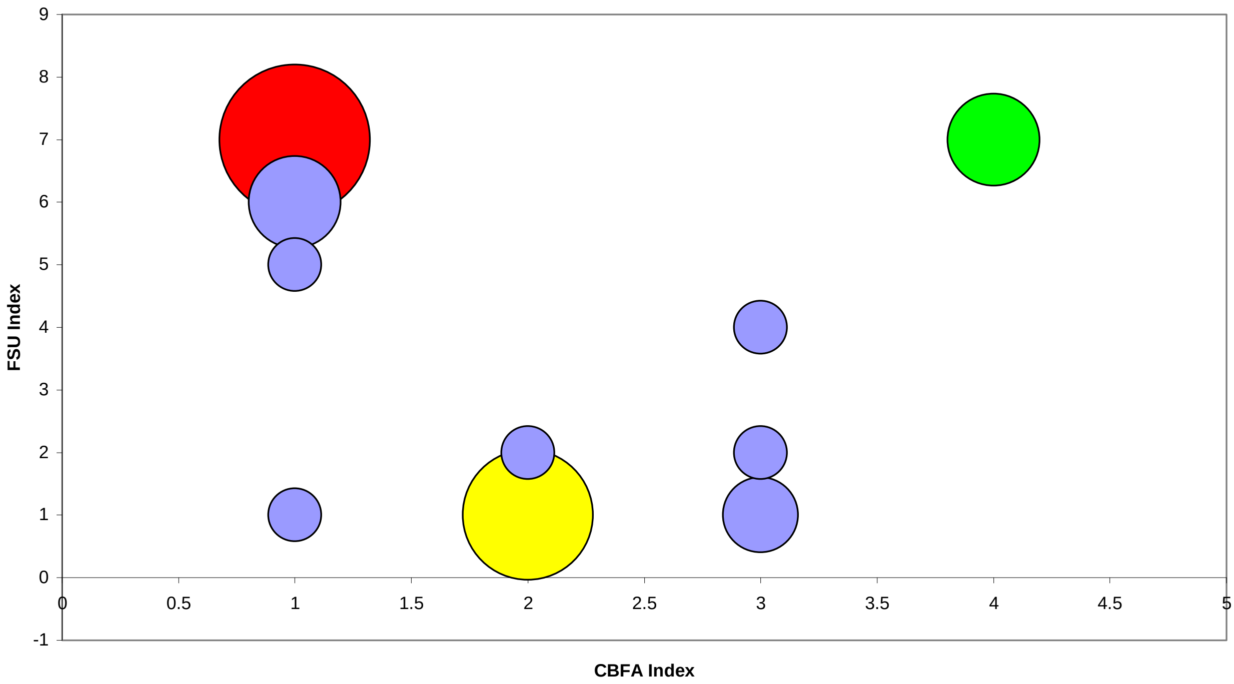


Figure 4 Financial Supervision Regimes



Note: the axes represent the two indexes, while the diameter represents the number of countries for each regime.

Table 1 The institutional indicators

FSU INDEX The index was built on the following scale: 7 = Single authority for all three sectors (total number of supervisors=1); 5 = Single authority for the banking sector and securities markets (total number of supervisors=2); 3 = Single authority for the insurance sector and the securities markets, or for the insurance sector and the banking sector (total number of supervisors=2); 1 = Specialized authority for each sector (total number of supervisors=3). We assigned a value of 5 to the single supervisor for the banking sector and securities markets because of the predominant importance of banking intermediation and securities markets over insurance in every national financial industry. It also interesting to note that, in the group of integrated supervisory agency countries, there seems to be a higher degree of integration between banking and securities supervision than between banking and insurance supervision ; therefore, the degree of concentration of powers, *ceteris paribus*, is greater. These observations do not, however, weigh another qualitative characteristic: There are countries in which one sector is supervised by more than one authority. It is likely that the degree of concentration rises when there are two authorities in a given sector, one of which has other powers in a second sector. On the other hand, the degree of concentration falls when there are two authorities in a given sector, neither of which has other powers in a second sector. It would therefore seem advisable to include these aspects in evaluating the various national supervisory structures by modifying the index as follows: adding 1 if there is at least one sector in the country with two authorities, and one of these authorities is also responsible for at least one other sector; subtracting 1 if there is at least one sector in the country with two authorities assigned to supervision, but neither of these authorities has responsibility for another sector; 0 elsewhere.
CBFA INDEX For each country, and given the three traditional financial sectors (banking, securities and insurance), the CBFA index is equal to: 1 if the central bank is not assigned the main responsibility for banking supervision; 2 if the central bank has the main (or sole) responsibility for banking supervision; 3 if the central bank has responsibility in any two sectors; 4 if the central bank has responsibility in all three sectors (In evaluating the role of the central bank in banking supervision, we considered the fact that, whatever the supervision regime, the central bank has responsibility in pursuing macro financial stability. Note that the countries of the Euro area are not monetary authorities. Therefore, we chose the relative role of the central bank as a rule of thumb: we assigned a greater value (2 instead of 1) if the central bank is the sole or the main authority responsible for banking supervision.

Source: Masciandaro 2007