1. Introduction

As the integration of financial markets has picked up speed in recent years, the subjects of supervision and crisis management of internationally active banks have gained in importance. Clearly, policy actions are needed to cope with the challenges arising from financial integration. One area in which such action is needed is supervision. To improve crisis preparation within Europe it would be useful to create a special body for supervision of the major cross-border banks. For the sake of this paper let us name this body the European Organisation for Financial Supervision (EOFS).

2. Lessons from the Past

Before elaborating on this proposal, it is important to note that financial and banking crises can involve large economic and political costs. There are several historical examples, such as the depression in the United States and the hyperinflation in Germany during the 1930s. After the Second World War, the conclusion was that the financial sector needed to be heavily regulated. Although this gave national authorities a certain control over risks in their own financial sectors, it also stifled competition, product development, efficiency and proper risk management. From the 1970s onwards, as these inefficiencies became larger and more apparent, many countries began to deregulate. Several countries, including Sweden, experienced costly banking crises partly because the new deregulated environment posed new challenges for banks as well as for regulators; challenges for which they were not prepared.

Eventually banks developed more appropriate risk management techniques and supervisors adopted a more risk- and process-oriented form of supervision rather than the previous rather formalistic approach. This has clearly lowered the risk of financial crises.

3. Internationalisation of Banking

Following deregulation, most banks remained predominantly national. Only in the past decade have we seen the emergence of some big cross-border banks with major activities in several countries. And this financial integration is accelerating. Clearly, this development is positive for the economy. It stimulates competition and product development across countries, and allows banks to take advantage of economies of scale and scope. The spread of cross-border banking has reached different levels in different parts of the world. In Europe it has been increasing
rapidly in recent years, but there are also several active cross-border banking groups in the Pacific region.

This integration is not without challenges. In particular, supervision and crisis management arrangements have to be addressed before the next crisis erupts. A useful parallel is perhaps the most burning global issue: the problem of global warming and climate change. The challenges of financial integration share some of the same characteristics as the environmental problems facing us; in particular, the problem of negative externalities.

The impact of industry emissions on the environment is the classic example of what economists call negative externalities. If the market is left on its own, polluters will not bear the social costs of their pollution. The same reasoning can be applied to financial crises. A crisis that severely affects the functioning of the financial system will result in substantial costs across the economy. These losses in output go far beyond what financial firms can possibly take – or be willing to take – into account when conducting their day-to-day business activities.

With regard to both pollution and financial crises there are ways to manage negative externalities. Public intervention can be used to internalise the negative externalities. For industries polluting the environment, authorities can impose taxes or issue emission rights, for example, to compensate for the social cost of pollution. For banks and financial firms this is achieved by regulatory and supervisory measures, such as capital requirements and rules for the establishment and conduct of business, as well as provisions giving central banks the right to grant emergency liquidity assistance.

4. Many Stakeholders, but No Single Authority

If the negative externalities can be contained within national borders, it is relatively straightforward to empower national authorities to act on both environmental problems and financial calamities. However, negative externalities are much more difficult to contain when they spread across national borders. To correct them requires some kind of supra-national organisation or some form of cross-border agreement.

For example, when banks become important in several countries, there may be a mismatch between the problems faced by, and the roles of, financial supervisors in different countries. Prevailing regulatory structures have very few supervision and crisis management arrangements that are designed to manage cross-border crises. Given that financial markets have become more integrated over time, the lack of adequate cross-border regulatory structures creates a number of challenges.

5. Challenges

One challenge presented by cross-border banking is that it increases the interdependence between countries. In particular, problems in the banking system in one country are more likely to spill over to the other countries where the bank or group is active. This can be illustrated by one of the largest Swedish banks, Nordea.
It has substantial activities in four of the Nordic countries, and is a significant part of the financial system in all these countries. Therefore, any serious problem in Nordea will most likely affect all four countries.

A second challenge is that decisions and actions by national authorities are likely to have considerable implications for financial stability in foreign economies. This is of course particularly true in cases where foreign operations are run through branches, meaning that they are subject to foreign supervision. However, in Europe at least, the consolidating supervisor also has an increased influence on foreign subsidiaries, within the new capital regulation framework of Basel II. In the Nordea case – which is now a group with a subsidiary structure – the Swedish consolidating supervisor can influence the risk management of the group as a whole as well as the different subsidiaries. Nordea has now announced plans to convert its subsidiaries in the Nordic countries into branches. When, and if, this plan becomes a reality, Swedish authorities will have the full responsibility for supervising three foreign branch networks, all of which may be of systemic importance in the different host countries.

A third challenge is that the legal distinction between branches and subsidiaries is becoming blurred. Increasingly, banking groups are starting to organise themselves along business lines rather than along legal and national lines, concentrating various functions in different centres of competence. While there are several examples of this trend, Nordea is again an illustrative case to consider. To reap the benefits from economies of scale and scope, Nordea has chosen to concentrate certain functions, such as treasury operations, credit decision-making and risk management to specific centres of competence within the group. It is therefore questionable whether the different entities within the group really are self-contained, even if they are legally independent subsidiaries. With this structure, it is also less likely that the group as a whole can survive a failure of one of its entities. Hence, operationally and in economic terms, Nordea increasingly resembles a bank with a branch structure. A consequence is that the present regulatory structure may be less suited for efficient supervision and regulation of the group.

A fourth challenge is that the practicalities of supervision and crisis management are greatly complicated as the number of relevant authorities multiplies. In normal times, this means that the regulatory burden for financial firms rises. Also, the need for supervisory cooperation increases, which demands new supervisory procedures and the creation of common supervisory cultures. During financial crises, it is important to share information and to coordinate actions but it may be difficult to do this in an efficient manner because time is such a scarce commodity.

A fifth challenge is that conflicting national interests emerge as banks become truly cross-border. National authorities have a national mandate and are responsible to the national government or parliament. They are therefore unlikely to take into account the full extent of the effect of their actions on other countries. Different countries may also have different priorities in terms of resources for supervision and crisis management, or in terms of their regulatory structures. One reason may be that financial systems differ quite significantly between countries. Additionally, the use of public funds can never be completely ruled out when dealing with crises.
In a cross-border context, serious conflicts of interest can arise when it comes to agreeing on how to share the potential burden of such interventions.

All these challenges have a common theme. Increasingly, national financial stability is becoming dependent on the activities of banks and authorities in foreign countries. Also, given the roles and responsibilities of these authorities, conflicts of interest are likely to occur. The typical illustration of this problem is a bank that is of limited size in the home country but has a systemically important branch network abroad. While a potential failure of the bank would not create any substantial disturbance in the home-country economy, the consequences for the host country could be destructive. The host country is likely to end up with the bulk of the bill for resolving any failure, so the willingness to conduct close supervision of the bank is substantial in the host country. However, the same cannot be said for the home country.

Financial integration also raises a number of practical issues. Do the current legal frameworks provide authorities with the necessary tools for supervising cross-border banking groups in an efficient way? And do the authorities themselves have arrangements in place to produce comprehensive assessments of the operations and the risks of these groups? Under the prevailing regulatory structures, I am afraid that the answer to both of these questions is likely to be no.

6. Policy Actions Are Needed

To deal with the challenges outlined in the previous section, existing regulatory frameworks must be revised. We must find a way for countries to cooperate closely and establish mechanisms for coordination and conflict resolution.

6.1 Motives for a coordinated financial supervision

The analysis so far is uncontroversial both in terms of identifying the challenges raised by integration and of the need for action. However, it may be more difficult to reach agreement on how to proceed. A number of alternative solutions have been suggested. For example, proposals such as prohibiting foreign branches from doing business domestically or extending home-country responsibility have been discussed.

A more efficient solution is to gradually move towards the creation of a common international body with a mandate to conduct supervision of banks with substantial cross-border activities. The simple rationale is that the creation of such a body is the only way to fully manage conflicting national interests. Such a body would have several other benefits. A single authority supervising cross-border banking groups would increase the comprehensiveness and the effectiveness of supervision. For the firms subject to supervision, it could also mean that the regulatory burden would eventually be reduced considerably.

In a European context, the idea of a EOFS may at first glance seem too idealistic, and in some respects it is. It may be virtually impossible to make countries give
up parts of their sovereignty to a supra-national authority. However, looking at this from a European perspective, there is hope. Within the European Union there is already a framework for supervisory and regulatory cooperation, based on the common legislative process in the form of European Union directives and regulations. Moreover, some institutional arrangements for supervisory cooperation are already in place, even if they do not have any legal powers. It may therefore be easier to make progress in Europe than elsewhere in the world. Still, even in Europe, it is not very likely that a fully fledged pan-European supervisor can be established in the near future. Therefore, the EOFS proposal should be seen as a gradual process rather than a fast-track to a European Financial Supervision Authority.

6.2 Institutional set-up and powers of EOFS

Because the EOFS is a new creation, it is important to outline how it should work and what its institutional set-up should be. The mandate of the EOFS would be to undertake a form of supervision of the major cross-border banks at the European level. As the focus is strictly on prudential supervision, the supervisory tasks related to market conduct and consumer protection would remain with national supervisors.

Aligned with the EU principle of subsidiarity, the supervisory duties of the EOFS should only include the banks with major cross-border activities. This would require a three-layered structure. The 8,000 or so European banks that mainly operate domestically would remain under the exclusive supervision of national authorities. The regionally oriented banks, active in a few countries, could use a structure similar to that of today, where supervisory colleges deepen cross-border cooperation. The limited number of truly pan-European banks would on the other hand be dealt with by the EOFS.

The initial tasks for the EOFS would be threefold: first, it should gather information about the banks and groups with significant cross-border activities; second, with the information acquired, unified risk assessments should be produced for the institutions subject to EOFS supervision; and third it should oversee the activities and risks of these institutions.

The EOFS should, at least at the outset, second staff from national supervisors and central banks. Initially the EOFS should probably have only limited powers, namely to collect information and undertake on-site inspections together with national supervisors. All other powers, such as licensing activities, regulations, interventions and corrective actions would still remain the responsibility of national supervisors. Consequently, the EOFS would act alongside the national authorities in producing comprehensive risk analysis of the designated banking groups and providing advice on policy actions to the national authorities. In the event of conflicting interests between authorities, the EOFS could also act as a neutral mediator.

Further, the coordinated European supervision of banks and groups with significant cross-border activities would facilitate a more efficient management and resolution

1. Subsidiarity can be described as the principle that any public tasks or regulations should be handled at the lowest level of government, where it can be made to work efficiently.
of cross-border crises. It would be easier to reach a common assessment of the systemic importance as well as the solvency of the bank or group in question.

In this sense, the EOFS in its embryonic stage would function more like a non-regulatory central bank than a traditional supervisor. The EOFS would conduct macro-prudential oversight and act as an enlightened speaking partner for the supervisory authorities.

It is important for the EOFS to be a separate agency with an independent status. This is necessary not least because the EOFS would need a high level of operational independence and integrity to be successful. It is also important to achieve a necessary division of power. The EOFS should cooperate closely with other organisations but should be free from direct guidance and involvement from national authorities as well as from the European Commission and the European Central Bank (ECB). Therefore, it should be given the same independent status that the ECB has today. Also, with many other pan-European regulatory bodies already in existence, it should not be too hard to come up with appropriate financing arrangements.

If successful in its initial role, the tasks of the EOFS could be gradually extended by assuming additional supervisory powers for the truly cross-border banks. However, it would first have to prove its merits.

As long as the EOFS operates in addition to the national authorities, another layer of supervision will be added to the present structure. From an industry perspective this would imply a greater regulatory burden. However, hopefully this is something that authorities and banks can live with if overall supervision improves and if the proposal results in a lower regulatory burden in the future.

People acquainted with the present regulatory and institutional set-up within the EU may ask if a version of the EOFS does not already exist, considering the present consolidated supervisory model and the role of the Committee of European Banking Supervisors (CEBS). However, even if both of these functions have their obvious merits, they do not quite satisfy the same needs. The mandate of the CEBS is to promote harmonisation of regulatory frameworks and not to conduct ordinary supervisory work. Even if the consolidated supervisor has group responsibility, it is an undeniable fact that the authority answers to the home-country constituents. Thus, the EOFS would contribute important functions in addition to the present regulatory structure within the EU. The EOFS should be an institution with real resources and not a ‘talk shop’ primarily designed to build consensus.

7. Conclusions

To summarise, it is apparent that during the past decade, the banking sector has become increasingly active across borders. This rather new form of financial integration is clearly positive. It enhances competition and stimulates economic growth. However, the development also raises challenges for the regulatory community. The answer to these challenges should not be increased protectionism. Instead, it is necessary to find new forms of cooperation and supervision that allow
the benefits from integration to be realised. The proposal to create a special body with
the mission to supervise the major European cross-border banks is an appropriate way
forward. Since this proposal may seem rather radical to some people, and infeasible
in the shorter term, the gradual approach would make it possible to reap some
benefits while at the same time strengthening the financial stability arrangements.
The time has now come to set up the means to achieve this goal.

The European focus of this proposal is based on the fact that there are already
institutional arrangements in place that can be used as a platform for achieving the
goal of supra-national supervisory frameworks. However, the underlying challenges
of financial integration are of a global nature. Therefore, even if it is not possible
to achieve the same solutions outside Europe, it should be of wider international
interest to at least move in the direction of enhanced cooperation between supervisory
authorities. Hopefully, this proposal can serve as an inspiration for further discussions
on this issue.

Considering that financial integration is already widespread and that the process of
revising present regulatory structures will most certainly be demanding and protracted,
there is urgency in starting the process. History shows us the importance of having
proper regulatory structures in place. Therefore, it would be highly unfortunate if
the appropriate measures have not been taken before the next major financial crisis
occurs. For once, it would be encouraging to see pre-emptive policy actions rather
than a crisis being the catalyst for such actions.

Thus, in the same way that the international community is facing increasing
challenges to cope with the negative externalities in the environmental area, financial
regulators have to face the consequences of financial integration. It is important to
show enough courage and determination to tackle the negative externalities that a
potential financial crisis would entail – before it hits us.

In this context, it is also important to note that the issue of financial integration
comprises many more aspects than merely setting up supervisory structures for
cross-border banks. For example, questions on how to establish proper arrangements
for emergency liquidity assistance and deposit guarantee schemes also need to be
considered within the same context. Even though these issues are of a somewhat
different nature, they do require the same type of supra-national considerations. The
simple reason is that it is only when the frameworks for regulation, supervision and
crisis management match the actual structure of financial markets, that the negative
externalities of financial crises can be managed properly.