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**ITEM VI ON THE AGENDA: SUPERVISORY COORDINATION IN THE EU**

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The question of supervisory coordination is central to the debate on the supervision of EU banks at the moment. It is particularly relevant given that:

- the European Financial Services Round Table (EFR) has published a paper entitled "Towards a Lead Supervisor for Cross Border Financial Institutions in the European Union" (*Enclosure 1*);
- the proposal for a Directive implementing the revised Basel Accord in the EU (the Capital Requirements Directive (CRD)) gives the consolidating supervisor a strong role in the supervision of banking groups;
- the Directive on the Prudential Supervision of Financial Conglomerates will come into force on 1 January 2005;
- the Committee of European Banking Supervisors is currently carrying out extensive work on the interaction between the home and host supervisors.

The EFR paper identifies the pressing need for a supervisory framework in the EU which is line with the objectives of the Single Market. Currently internationally active banking groups are subject to inconsistent interpretation of European legislation and costly duplication of both systems and work. The establishment of CEBS is a positive step towards enhanced supervisory cooperation and eventual convergence of practices. However, it is clear that a framework must be put in place quickly to facilitate the implementation of the FSAP and the growing complexity both of financial instruments and of risk management practice.

The EFR paper is particularly interesting in the context of the consolidating supervisor as proposed in the CRD. Between the publication of the third consultation paper and the proposal for a Directive the Commission agreed that the Directive could not work without a strong role for the consolidating supervisor. The consolidating supervisor will have a significantly stronger role than the coordinating supervisor in the Financial Conglomerates Directive.

The model set out by the Commission in the proposal for a Directive respects the role of national competent authorities whilst providing a single point of contact for validation of the advanced models (IRB and AMA) in the Directive. While a college of supervisors *per se* is not envisaged at this stage, the consolidating supervisor will work closely with the host competent authorities in determining an application. The Directive introduces a six month period in which host supervisors should agree or compromise. After that period the lead supervisor decides alone.

The FBE has welcomed the Commission's inclusion of the model in the proposal for a Directive. However, there are still strong concerns over the potential for inconsistent treatment of internationally active groups if the consolidating supervisor does not have responsibility for the Supervisory Review Process under Pillar 2 of the Directive. It is not clear how Pillar 2 can work in practice if it is not applied at the level of the group.

The consultation paper differentiates between the Institution's Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP). While ICAAP takes place in most banks at group level, SREP will take place at solo entity level. This leads to two crucial problems. Firstly the calculation of capital at group level reflecting the risk profile of the group as a whole, cannot equate to the capital calculations resulting from measurement of risk at solo level. Secondly, Pillar 2 is the least concrete of the three pillars and as such will be subject to quite different interpretation by supervisors.

As part of its ongoing workstream, CEBS is researching the interaction between home and host supervisors. The members of CEBS naturally feel that, if the SREP is not applied at solo level within the group, there will be no mechanism to ensure adequate allocation of capital in host jurisdictions. It is not clear for the moment how CEBS perceives the fit between the two elements of the Supervisory Review Process. The EFR paper clearly states that one of the responsibilities of the lead supervisor should be to ensure adequate allocation of capital throughout the group.

Enclosure: 1



# 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





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**JUNE 2004**

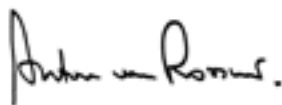
## Foreword

Efficient and effective supervision of financial institutions is a necessity for the further growth and integration of European financial markets. In its first paper about Regulation and Supervision (October 2003), EFR had identified the concept of the lead supervisor as a powerful tool to achieve this goal.

This second paper gives a clear definition of the concept, together with pragmatic suggestions about its implementation.

Other important issues, related to the concept of the lead supervisor, such as the lender of last resort or guarantee schemes will be treated in a separate study.

The EFR looks forward to participating actively in the much needed debate about the future organisation of financial regulation and supervision in the EU.



Anton van Rossum  
Sponsor of the EFR Steering Group  
on Regulation and Supervision



Pehr G. Gyllenhammar  
Chairman of the  
European Financial Services Round Table

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## Executive summary

- In its first paper about Regulation and Supervision, issued in October 2003, the European Financial Services Round Table (EFR) recommended that prudential supervision of financial institutions should focus on solvency and liquidity. The growing complexity of the financial environment, the ongoing integration of European financial markets and new regulatory initiatives like Basel II and Solvency II, increase the need for more convergence of the supervisory practice. A clearly defined lead supervisor for prudential supervision of cross-border financial institutions would be an important step towards a more coherent and efficient supervisory framework in the EU. This second paper defines how the lead supervisory regime should function and how it could be implemented.
- The job of the lead supervisor, who could also be called a consolidating supervisor, should be clearly defined and fully empowered. This means that he or she should be the single point of contact for the financial institution within the prudential supervisory framework. In particular, the lead supervisor should be the single point of contact for all reporting schemes, validate and authorise internal models, approve capital and liquidity allocation, approve the cross-border set-up of specific functions and decide about all on-site inspections. The lead supervisor should be responsible for supervision, not only on the consolidated level, but also on the local and the sub-consolidated level.



- Local supervisors of those countries in which the financial institution has establishments should be involved in the supervisory process. Local supervisors could execute local inspections, based on a delegation by the lead supervisor. Furthermore they, together with the lead supervisor, should form a college, one college specific for each group. This college can advise the lead supervisor and discuss proposals of involved local supervisors but would not have the power to delay decisions of the lead supervisor. The college should be informed of the situation of those supervised and on relevant developments by the lead supervisor on a regular basis. In case of lasting differences of opinion with the lead supervisor, members of the college should have the possibility to submit the issue(s) at stake to the relevant Lamfalussy Committee – i.e. CEBS, CEIOPS or the Conglomerate Committee which could either act in an appeal procedure or could organise a mediation process.
- The EFR's concept of the lead supervisor could be implemented in three stages:
  - Immediately, the already existing possibilities for delegation of supervisory powers between bank supervisory authorities should be used extensively.
  - If this is not the case yet, Member States should introduce the possibility of delegation provided by the Second Banking Directive in their national legislation.
  - Notwithstanding the use of delegation powers, a legal foundation of the lead supervisory regime for banks, insurance companies, investment firms and financial conglomerates should be established, in the shape of an EU directive, as soon as possible and after consultation with the industry.

**Conclusion:**

The EFR believes that implementation of a lead supervisory regime in the EU is both urgent and feasible. It will be an important step towards closing the now widening gap between supervisory structures and market practice. In an ever more integrated financial market – one of the major goals of the EU – it is unacceptable and inefficient that financial institutions have to cope with a multitude of independently acting local supervisors, each responsible for part of the institution and each developing his or her own practices. Even if the co-ordinator function as created by the so-called Financial Conglomerates Directive is a first positive step, it does not go far enough.

The lead supervisory regime will not only improve the quality of supervision at an acceptable cost. Its implementation will also be an important catalyst in the EU in boosting the convergence of supervision towards best practices.

# 1 Introduction

In the recommendations paper issued in October 2003, the EFR suggested that the original goals of prudential regulation and supervision of financial institutions, which are to guarantee their solvency and liquidity position, should once again become priority issues on the political agenda. Other matters of concern, such as customer protection, taxation or codes of conduct should be treated separately.

The organisation of European prudential regulation and supervision should increasingly take into account the ongoing integration of the European financial markets, and should even encourage this development, given its positive effects on competition and growth. A political debate on the ultimate structure of the European supervisory framework remains necessary, as several possible structures have already been proposed. Nevertheless, the most urgent concern is to organise regulation and supervision in a coherent and consistent way throughout Europe.

Continuous pressure to get both a consistent and timely implementation of European rules is necessary, as well as increasing the convergence of supervisory practice and reporting. The so-called Lamfalussy approach, now extended to banking, insurance and occupational pensions, as well as conglomerates, creates an environment where these issues can be properly discussed, leading to pan-European guidelines and standards.

In its recommendations issued last year, the EFR considered the principle of “home country control” is in itself a powerful tool to achieve more coherent and efficient supervision of cross-border financial institutions, if implemented properly. The home country control approach is currently limited to a cross-border structure of branches of the intermediary being monitored. As soon as subsidiaries are involved, the host country has full responsibility and freedom of control over these subsidiaries – even though the home supervisor is, in any case, responsible for supervising institutions on a consolidated basis. In liquidity issues, the host country is responsible, even for branches. The only way to simplify this complex structure is to make the home country control approach generally applicable, irrespective of the fact that a legal structure of branches or subsidiaries is used and to extend it to the supervision of liquidity. The concept of generalised home country control leads to the necessity of a clearly defined and fully empowered lead supervisor for each financial group, who takes responsibility for all supervisory tasks within the EU territory.

It is urgent to put the concept of the lead supervisor into practice. Prudential regulation and supervision is in the process of evolving from a simple, uniformly quantitative approach towards a more qualitative assessment, taking into account the actual complexity of the financial environment. Compared to Basel I, the framework of Basel II is a clear example of this evolution. The development of Solvency II for insurance companies will follow the same philosophy. More qualitative approaches leave more room for different interpretations and practices. In the third consultation paper about capital requirements for banks and investment firms (March 15, 2004), the Commission Services propose a number of procedures to avoid this problem, but they do not go as far as the concept of a lead supervisor. The lead supervisory framework can ensure that a financial group will not be subjected to diverging rules imposed by several European supervisors. At the same time, in order to provide for a level-playing-field, it is necessary that EU supervisors further align their supervisory standards and practices, as envisaged, *inter alia*, in level 3 of the Lamfalussy process.

The present paper proposes solutions for the extension of the home country control principle within the EU through the concept of a lead supervisor. The EFR considers discussion of this concept as part of an open and ongoing debate on the future structure of financial supervision in the EU. The lead supervisor concept has the advantage of being achievable in the short-term, while not precluding the future realisation of more far-reaching institutional structures. The present paper describes the functions of the lead supervisor, the framework for co-operation between the lead supervisor and the local supervisors, and some legal aspects of the lead supervisory environment. Other important issues, related to the lead supervisor, such as the function of lender of last resort and guarantee schemes, will be treated in a separate study.

## 2 The concept of the lead supervisor

The primary goal of a lead supervisory system for cross-border financial institutions is to make supervision more efficient, more coherent, more effective and less expensive.

Multiple reporting for different regulators, with each report being slightly different from the others, but nonetheless necessitating customised arrangements of the databases in the end, is expensive and does not yield any benefits in the shape of a clearer picture of the financial institution. A financial group with establishments in different Member States should be able to discuss with one (and only one) regulator the global framework of its prudential supervision, as more and more functions are organised cross-border. A local supervisor looking only into the operations of the establishment in his or her country can no longer understand the economic and financial rationale of the global set-up of the institution. The necessity of the institution having to convince each local supervisor about the global set-up, while each local supervisor has his or her own approach and preferences, is extremely time-consuming, expensive and burdensome. This is a major hurdle for further cross-border integration of the financial industry.

The EFR is convinced that it would be an important achievement if cross-border financial institutions could deal with only one supervisor, the lead supervisor who could also be called the consolidating supervisor. The lead supervisor should have extended responsibilities and power for the consolidated group as well as for each of its individual operations, which fall under the lead supervisory control.

The lead supervisor should:

- be the single point of contact for the financial institution with the supervisory framework. This should be the case for all issues of solvency and liquidity at the group level as well as at the solo level independent of the legal structure i.e. either a branch or a subsidiary (wholly owned or fully controlled);
- have the authority to decide on all reporting schemes concerning solvency and liquidity at both group level on a consolidated basis and at the local level or sub-consolidated level (if need be);

- validate and authorise internal models at both group and local level. This should allow a consistent approach of risk management throughout the group;
- decide about “pillar 2” rules in the framework of Basel II and Solvency II at both group and local level, once again to guarantee consistent approaches within the cross-border institution;
- approve capital allocation within the group and take into consideration group-wide diversification effects. Capital allocation should become a top-down approach instead of a bottom-up approach. Capital adequacy should be assessed at the group level first;
- decide on on-site inspections, to be executed occasionally by the host supervisor based on instructions by the lead supervisor. This necessitates co-operation between the supervisors involved, which is in itself a catalyst for further convergence of supervisory practices within the EU;
- have the power to approve the cross-border set-up of specific functions within the group (risk management, single booking entity, IT platforms, payment systems, custody, clearing and settlement functions, etc...). It should be recognised that these cross-border set-ups within a financial group are different from the traditional outsourcing practice;
- set up the liquidity rules at group and local levels, as in practice treasury management of cross-border groups is more and more a centralised function, particularly within the Euro-zone;
- co-ordinate the authorisation (licensing) procedures of financial institutions in Member States. Licensing should be a straightforward and totally standardised procedure.

To summarise, the lead supervisor would act in exactly the same manner for a subsidiary (wholly owned or fully controlled) as he or she acts for a branch in the present home country control model (with an extension to liquidity supervision).

Moreover the lead supervisory function should be clearly defined and identical across Member States.

While, for a financial conglomerate, the lead supervisor should take responsibilities for all the individual entities of the conglomerate - banks, insurers and investment firms -, this is perhaps not achievable in those countries where supervision of banks, insurance companies and investment firms is executed by different authorities. In that case, cross industry financial institutions should have a lead supervisor for each type of operation, while one of them would also be the co-ordinating supervisor, as defined in the Conglomerates Directive.



### 3 The concept of the college of supervisors

While the lead supervisor should be fully empowered to take decisions, this does not mean that he acts without support from the local supervisors in those Member States where any given financial group has establishments. Conceptually, it is desirable that the local supervisors who generally have a better understanding of the local market conditions can give input to the decision making of the lead supervisor. Practically, execution of local inspections can sometimes be better delegated by the lead supervisor to the local supervisors.

The co-operation between the lead supervisor and local supervisors can be organised through the establishment of a college of supervisors involved, specific for each group. The college would advise the lead supervisor. The lead supervisor would regularly inform the college of the situation of the group. At the same time the college would act as a forum for an exchange of information between the supervisors involved, and discuss proposals of the involved local supervisors.

In case of a crisis, the college would become a “management team” where the lead supervisor acts as *primus inter pares*.

The lead supervisor concept obviously requires close co-operation and a high level of confidence between supervisors. However, in cases of lasting differences of opinion, members of the college should have the possibility of referring the problem to CEBS, CEIOPS or the Conglomerate Committee. Those committees could either act in an appeal procedure or could organise a mediation process between the supervisors involved. The involvement of these committees will further enhance their role in defining best practices for the EU-supervisors.

A properly organised system of colleges of supervisors, combined with a possibility for appeal to the relevant Lamfalussy committee would dramatically reduce the risk of externalities, i.e. the risk that the lead supervisor makes decisions, which would have unacceptable consequences in a host country.

The functions of the respective colleges should be clearly defined and identical across all Member States.

## 4 Implementation of the concept of the lead supervisor

For the implementation of the lead supervisor concept, the EFR proposes the following three-stage process:

- 1) extensive use of existing legal provisions in the form of delegation of supervisory powers in the context of the Second Banking Directive and bi-multilateral memoranda of understanding;
- 2) all Member States should introduce the possibility of delegation provided by the Second Banking Directive within their national legislation. Accordingly, national supervisors should then make intensive use of powers of delegation;
- 3) given the extensive and important powers of a lead supervisor, a legal foundation in the shape of an EU directive should be established. The EFR encourages the EU Commission to put forward a proposal for such a directive – covering banks, insurance companies and investment firms – as soon as possible, after consultation with industry.

Even if a complete legal framework is not yet available, it is possible in some cases, at least in the banking industry, to immediately implement both concepts of the lead supervisor and of the college of supervisors by using the existing legal framework more extensively. The Banking Directive 2000/12 provides, in article 52-9, the possibility for a local supervisor to delegate monitoring powers concerning solvency (but not liquidity) to the supervisor who monitors the mother company. Such delegation of powers is to be acknowledged through a memorandum of understanding between the two supervisors. The EFR proposes a generalisation and standardisation of such memoranda of understanding, which could provide for the establishment of the college of supervisors and of the lead supervisor with the respective responsibilities as described above.

The Conglomerate Directive already provides for the nomination of a co-ordinating supervisor, who could be considered as the “natural” lead supervisor if the responsibilities are properly extended.

Today, the banking and the insurance industries are not on the same level when it comes to group-wide supervision. The evolution towards consolidated supervision is now speeding up for the insurance industry. However, the fact that the implementation needs to be amended for the insurance industry should in no way prevent the banking industry from having its college of supervisors and its lead supervisor designated.

For pragmatic reasons the EFR proposes that the lead supervisory regime should be limited to wholly owned (or fully controlled) subsidiaries within the EU. For European financial groups also active outside the EU, co-operative arrangements with the involved non-EU supervisors need to be put in place to minimise the cost to the industry and insure that supervision is as consistent as possible.

The EFR recommends that within the EU, the lead supervisory regime becomes the standard approach for the supervision of cross-border financial institutions. However, these institutions should have the ability of deviating from this principle to remain under the existing supervisory arrangements, if they have specific reasons rooted in, for instance their size, business or management approach.

In the same way, the financial institution under a lead supervisory regime should be allowed to decide that certain subsidiaries remain under local supervision. These decisions should be made with full transparency and in agreement with the supervisors.

## 5 Conclusion

Implementation of the lead supervisory regime in the EU is both urgent and feasible. It will be an important step towards closing the now widening gap between supervisory structures and market practice. In an ever more integrated financial market – one of the major goals of the EU – it is unacceptable and inefficient that financial institutions have to cope with a multitude of independently acting local supervisors, each responsible for part of the institution and each developing his or her own practices. Even though the co-ordinator function as created by the so-called Financial Conglomerates Directive is a first positive step, it does not go far enough.

The lead supervisory regime will not only improve the quality of supervision at an acceptable cost. Its implementation will also be an important catalyst in the EU boosting the convergence of supervision towards best practices.

## About the EFR

The Members of the European Financial Services Round Table (EFR) strongly support the completion of the Single Market in the area of financial services. Creating true competition on a level playing field – with fully harmonised regulations and a single capital market – will bring substantial benefits to consumers across the 25 Member States of the European Union. These benefits will help to drive down prices and deliver a wider and better choice of financial products to consumers. The EFR provides a strong industry voice and participates actively in the debate aiming at a further integration of the financial services markets.

The EFR welcomes the effort undertaken both at the European and national level to accomplish the goals set by the Lisbon Agenda, including the Financial Services Action Plan.

The policy priorities of the EFR are:

- To promote effective and efficient financial regulation and supervision
- To encourage harmonisation of consumer protection rules in the area of financial services at European level
- To promote a Single Market for pensions
- To support a single capital market

The EFR has published, inter alia, a report on the major obstacles to a fully integrated financial market *The Benefits of a Working European Retail Market*, 2002; a report on the integration of pensions in Europe *One Europe, One Pension – Affording the Future*, 2002; recommendations on the *Harmonisation of Regulation and Supervision of the European Financial Sector*, October 2003; a statement on the European securities market infrastructure *Securities clearing and settlement in Europe*, 2003; and in March 2004 a report on consumer protection *Consumer Protection and Consumer Choice*.

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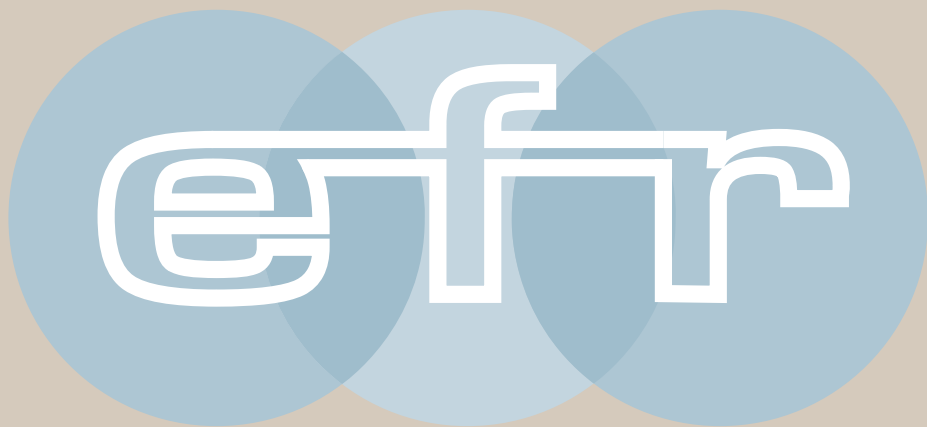
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