

DOCUMENTATIEBLAD

**PRUDENTIAL SUPERVISION IN AN INTEGRATING EU
FINANCIAL MARKET****Dirk HEREMANS¹ and Dries DE SMET², (K.U. Leuven)***Abstract*

Having constantly to adapt to financial innovation, globalization and new financial structures, financial regulation and supervision are increasingly becoming a puzzle. The EU-wide financial market integration progress certainly does not simplify the picture.

The huge efforts to bring about EU harmonized regulation contrast sharply with prudential supervision which remains fragmented among the EU member states. The difference in assignment of prudential supervision of branches and subsidiaries to home and host member states, is rather ambiguous. These assignments may also conflict with the surveillance of financial stability. For large financial groups operating cross-border and in particular in the new EU-10 member states, these supervisory conflicts may become serious. Contrary to the present gradual approach consisting in supervisory convergence and cooperation, more institutional EU involvement may be needed.

Finally, the evolution of the clearing and settlement industry in an integrating market is also becoming a new but not undisputed EU concern.

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INTRODUCTION

Worldwide the dynamic evolution in financial systems has been stirring up the regulatory debate. New information technologies are speeding up financial innovations: off balance sheet activities, derivatives, hedge funds are increasing leverage and affect risk profiles. Globalization of financial markets is rendering control by national authorities more and more difficult. Due to increased competition, the sectoral borders between financial institutions are fading, raising the issue of controlling large financial conglomerates.

In the European Union the ambitious financial services action plan (FSAP) aiming at an EU-wide financial market is speeding up financial regulation reform at EU level. Prudential supervision however remains the domain of the national member states and is raising many questions as to the appropriateness of such a supervisory framework in an integrated market.

The purpose of this contribution is to analyse the various challenges raised by EU financial market integration to micro-prudential supervision of the soundness and solvency of financial institutions as well as to macro-prudential surveillance of the stability of the EU financial system. Next the prudential policy responses to the many potential conflicts and coordination problems among member states will be documented. Finally, the question will be addressed to what extent the European Community is to be involved in prudential policy.

Moreover, these issues will have to be approached against the background of the broader regulatory debate, sometimes labelled as “the regulatory crisis”. The puzzle of widespread regulation and supervision in the financial sector, as will be documented first, is in the process of being revised. Prudential supervision should rely more on market discipline and the monitoring of privately developed risk management systems.

1. THE FINANCIAL REGULATORY PUZZLE

The financial sector differs from other economic sectors due to considerable systemic risks. In contrast to other sectors, there is a clear need for regulatory and prudential measures, as explained in section 1.2. In section 1.3, we address the question how financial supervision should be organized. We argue that in the last decades the call for increased reliance on market discipline has grown. But before we deal with these issues, we first give an overview of the overall regulatory framework in section 1.1.

1.1 THE OVERALL REGULATORY FRAMEWORK

The terminology in the area of financial regulation and prudential supervision

is not always transparent. Some preliminary clarification of the terminology as well as of the economic background of government intervention may be in order.

First, regulation refers to the establishment of specific rules of behaviour i.e. rulemaking. The application of the rules which has to be supervised, may be further distinguished in its micro-monitoring and macro-surveillance aspects. Micro-supervision or monitoring refers to observing whether the rules are obeyed by individual actors or institutions. The more global observation of the behaviour of financial institutions corresponds to surveillance or oversight.

Second, prudential regulation and supervision constitute a rather specific area in the overall regulatory framework and typically refer to the financial domain. This can be seen in the policy-matrix in table 1, listing the objectives in the rows. The micro-prudential objective is to maintain the soundness of individual financial institutions, the stability of the whole financial systems being the macro-prudential objective. Other areas of financial regulation aim at the efficiency of the market organisation through competition policy, and the integrity of transactions in products and services markets through conduct of business rules. Competition and conduct of business rules belong to the broader economic domain, and derive from policies that are also applicable to non-financial sectors. Some of the conduct of business rules may be specific to financial transactions and apply also to non-financial firms listed on the stock exchange.

Table 1: Policy-matrix of financial regulation and supervisors

OBJECTIVES SECTORS/ INSTITUTIONS	Competition: Efficiency of market organisation	Conduct of business: Efficiency and integrity of market transactions	Micro prudential Supervision: Soundness of individual institutions	Macro prudential Supervision: Surveillance of stability of the financial system	Monetary policy: Macro-stabilisation
Trading and post-trading Infrastructure Investment/Securities Firms Insurance Companies and Pension Funds Banks: Deposit and Credit Intermediaries					

In the column of the policy-matrix the major financial sectors and corresponding types of financial intermediaries are listed. Investment and securities firms, insurance

companies and banks are to a different degree subject to the different objectives of regulation and supervision. Moreover, banks are also involved in the monetary policy domain which aims at price-stability and short term macro-economic stabilisation.

Hence, financial regulation and supervision may involve wider policy-issues and be subject to trade-offs between the different policy-objectives and corresponding regulatory areas. Not enough attention is being paid to these interferences by the authorities in their policy-making. For instance, when competition authorities move into the financial sector, they may impact also upon the soundness of financial institutions and overall financial stability. Prudential authorities in a similar way may impact upon competition.

This contribution, after including some analysis of conduct of business concerns involving transactional rulemaking, will focus mainly on the supervisory approach, which relies more on monitoring and surveillance. The latter supervisory approach tends to be more relevant for financial institutions highly involved in asset-transformation on their balance sheets, such as banks. Transactional regulation of conduct of business tends to be more important for securities market transactions and for securities and investment firms.

Conduct of business regulation aims at the correction of market failures which may be due to external effects and information asymmetries. They attempt mainly to mitigate principal agent problems between producers and consumers in the market. In financial markets, due to the opaque nature of financial products, these distortions tend to be more severe, explaining also specific conduct of business regulation in the financial sector.

1.2 PRUDENTIAL REGULATION AND SUPERVISION

Informational imperfections in financial markets constitute also the economic basis for the emergence of financial intermediaries. By specialising in informational services and monitoring the behaviour of financial market participants, financial intermediaries help to solve adverse selection and moral hazard problems. By acting as delegated monitors, they contribute in mitigating agency problems, but in turn may create other agency problems. Hence, the question is who monitors the monitor (see Dewatripont and Tirole (1994)). The answer may be found in prudential regulation and supervision.

Contrary to conduct of business regulation, prudential regulation does not deal with the financial transactions as such, but it focuses on the regulation and supervision of financial institutions. In order to protect the interests of financial market participants such as depositors, insurance policy-holders etc., the solvency of these financial intermediaries should be guaranteed. This is the area of micro-prudential su-

pervision in which monitoring activities may be more important than rulemaking.

Financial institutions may also present particular external effects. The failure of a financial institution may entail social costs, as it easily may affect the solvency of other financial institutions. Sometimes a distinction is made between first and second round effects. A first round effect occurs when a financial shock causes the firm itself to fail. Financial problems may then spread throughout the institution to branches and subsidiaries, which may also be located abroad. Within financial conglomerates there are also cross-sectoral effects as banking problems spread towards insurance, investment and securities business, or the other way around. When the failure is transmitted to other institutions because of explicit financial linkages, a second round effect occurs. This may be due to domino-effects in the interbank market or in payment systems, or simply to imperfect information of other depositors leading to contagious withdrawals and a bank run (see Schoenmaker and Oosterloo (2005)).

This concern for financial stability is the economic basis for macro-prudential surveillance of the whole financial system. Traditionally it was also the primary objective of prudential regulation and supervision.

Originally in the prudential policy-field the emphasis was upon protective instruments such as emergency liquidity assistance by central banks, bail-outs of financial institutions with tax money and followed later by deposit insurance. The problem is that safety nets present moral hazard problems leading to more risk taking by financial institutions. Hence, the need for other prudential policies.

Measures to structurally limit competition enhanced the safety of financial institutions, however, at a high efficiency cost. Hence, the need for other prudential instruments to contain risk behaviour of financial institutions. Capital adequacy rules have been introduced worldwide at the end of the eighties within the framework of Basle I for the banking system. As capital requirements are linked to risk taking, it induces banks to better monitor their risks and contain excessive risk taking. The new Basle II framework attempts to improve the previous mechanical approach by making capital requirements more risk sensitive and improving internal risk management in pillar I of the regime. Pillar II calls for more supervisory review and pillar III emphasises disciplining by the market (see Heremans (2004)). Similar systems are being envisaged for other financial institutions as e.g. in Solvency II risk oriented calculations of the solvency requirements for insurance undertakings are to be introduced.

A major question remains as to what extent other financial institutions, such as securities firms and insurance companies, present systemic risks and are also to be subjected to macro-prudential supervision (see Heremans (2000)). Systemic risks for these intermediaries may have been increasing due to structural deregulation and the

emergence of large financial conglomerates comprising banks, securities firms and insurance firms. Changes in these financial structures are leading to an upheaval in the traditional institution-oriented supervisory architecture. As a result the supervision of banks, insurance companies and securities firms is also being merged within one supervisory structure.

1.3 GOVERNMENT SUPERVISION OR MARKET DISCIPLINE

The design of financial regulation and supervision is complicated by the changing vision on the role of government and by the increased reliance on market discipline.

In the last decades the awareness has grown that regulation not only entails benefits, but also imposes substantial costs on the economy. In particular structural regulation limiting competition in financial markets causes substantial welfare costs. This awareness has led to structural deregulation and liberalisation in the financial sector entailing a so-called regulatory crisis. Reregulation has taken the forms of prudential measures such as risk-based capital requirements which better correspond to market principles.

Regulation along prudential lines, however, imposes a substantial burden on the financial sector. The figures of regulatory costs amount to 5.3 percent of operating profits, 2.8 percent of value added in banking and 12 percent of non-interest expenses (see Kager (2006)). According to a World Bank comparative study for banking it would appear that the regulatory and supervisory burden in Belgium would be somewhat higher than the EU-15 average and would contain more structural measures limiting market operations. Market monitoring and discipline on the other hand appear to be less developed in Belgium (see Barth, Caprio, Levine (2001)). The observation eventually could be explained by the fact that the traditional supervisory approach in Belgium, relying on soft regulation and close monitoring of financial institutions, has been burdened in the transition period by the EU approach focusing more on explicit and extensive regulation. As the regulatory field is in transition, the World Bank Survey based on 2001 numbers may already be outdated. Whatsoever, the regulatory burden should be closely monitored, as it is also found that more severe regulation is not necessarily conducive to an efficient development of the banking system (see Barth, Caprio, Levine (2001)).

The growing concern for excessive regulation is underpinned by more recent fundamental economic research. Financial transactions are analysed as a complex structure of explicit and implicit contracts dealing with informational asymmetries and involving principal-agent-incentive problems. In this approach regulation and supervision become subordinate to creating incentives for good governance by institutions and delegated monitoring in the market (see Dewatripont and Tirole (1994)).

In the prudential supervision area more attention should go first to “internal governance” of institutions i.e. appropriate incentives for internal control procedures and for a risk-focused approach. Capital requirements are to be sufficiently flexible to allow the financial operators to develop their own risk management systems. The role of the supervisory authorities is to be limited to the supervision of these private regulatory systems. This corresponds largely to the approach ultimately envisaged by the Basle II framework for banks. The implementation, however, may still require a shift in the traditional supervisory attitudes and practices.

In second line, the emphasis is upon external governance. It is a question of disciplining by the market, i.e. private delegated monitoring by rating agencies, financial analysts and other specialised agencies. The role of government intervention is limited to regulate and supervise information disclosure, transparency, accounting and auditing rules...

In this approach corporate governance becomes a necessary complement and even a substitute for regulatory intervention (see Devriese e.a. (2004)). Since regulation is about changing the behaviour of financial institutions, this may be achieved as well through incentives for appropriate behaviour as by externally imposed rules. In this respect all aspects of behaviour of financial firms are ultimately to be qualified as corporate governance issues. Hence, within the present corporate governance debate, more attention should be given to specific agency issues for financial institutions. In particular, the corporate governance issues should also be viewed from a financial stability perspective which may imply different corporate governance recommendations for financial firms (see Heremans (2007)).

According to the same approach, also regulation and supervision should be analysed as incentive contracts within a principal-agent relationship. It implies regular regulatory review and accountability for the regulatory and supervisory authorities involved.

Whatever the further outcome of this ongoing discussion, it appears already that, due to financial globalisation and continuing financial innovation, externally imposed regulation is becoming increasingly inappropriate. A new balance is to be found between externally imposed regulation and the development of internal mechanisms.

2. THE EU DIMENSION

The globalisation of financial markets constitutes a major challenge to the regulation and supervision of financial activities which is left to the national authorities. It creates many problems of spill-over effects and potential systemic risks, also level playing field and regulatory arbitrage concerns, for which solutions are not

easy to implement.

As these issues are certainly not exclusive to Europe, the question arises as to its EU dimensions. In this respect the existence of an EU project on the single EU-wide financial market certainly does add an extra dimension to the problem.

2.1 THE EU INTERNAL MARKET APPROACH

Traditionally in the financial sector the primary objective of financial regulation and supervision has been to ensure the stability of the financial system, thereby also protecting individual investors and creditors against the risk of losses as a second objective. Concerns for the competitive functioning of financial markets as a third goal are of a more recent date.

Within an EU perspective the developments are unfolding themselves in an opposite order. The primary objective of policy making is the achievement of the single market for financial services. Hence the focus is upon the regulation and supervision of financial transactions, and their impact upon financial market integration. Concerns for cross border competition and conduct of business dominate. Also attention is increasing at the micro-level for cross-border protection of investors as the home-bias puzzle is gradually disappearing. Coordination of policies and harmonisation of regulation figure high on the agenda to achieve a level playing field in Europe. Financial stability does not come into the picture as the primary goal. This task remains with the national authorities, whereas at the same time European-wide systemic risks may emerge.

Hence, the EU is facing specific trade offs between the various objectives of prudential policies. A similar problem has been observed with respect to the implementation of European competition policy. Compared to US anti-trust policy it is much more dominated by market integration concerns, which may come at a cost in terms of economic efficiency (see Van Cayseele and Van den Berg (2000)). Too much emphasis upon competitive market integration in the EU may also conflict with the objective of financial stability.

The fact that financial market integration is the primary objective at the European level is initially contributing to a market approach. The traditional host country control rule according to which foreign firms must adapt to local rules constituted an important barrier to market integration. In the process it engendered forces towards the adoption of stricter regulation in order to protect domestic markets against foreign competition. Attempts to harmonise prudential regulation and subject new regulations to a community approval procedure proved to be unworkable.

This process was reversed by the new internal market approach based upon a decentralised approach of mutual recognition of regulation and home country control for supervision. It was held that competition of regulation among member countries eventually would lead to spontaneous convergence around best practices, the choice being made by the market. This rather revolutionary shift towards a decentralized approach certainly has contributed towards opening up financial markets (Van Cayseele and Heremans (1991)).

This approach has been rather successful for product markets relying very much upon transactional conduct of business rules. Potentially it may also be successful to achieve a single market for financial services. This, however, is less obvious for various reasons.

(i) Financial products and services are very information intensive and opaque. Due to severe information asymmetries and agency problems, they may require more regulation and supervision conflicting with the internal market approach relying upon mutual recognition and minimal harmonisation.

(ii) In the financial sector consumer and investor protection not only depends on conduct of business rules, but also on the safeguarding of the soundness of financial intermediaries. It requires prudential measures, which are less of a regulatory and more of a supervisory and judgmental nature.

(iii) Moreover, the prudential measures have also to be taken to protect the stability of the whole financial system. It includes safety nets such as deposit insurance, emergency liquidity assistance, and possibly bail-out operations which typically require host country intervention. Systemic concerns for the stability of the financial sector are of a “general good” nature for a country, and may conflict with home country control.

Hence, compared to other economic sectors, for the financial sector more conflicts are bound to arise between market integration and the various objectives of prudential regulation and supervision.

2.2 FOCUS ON EU FINANCIAL MARKET REGULATION

The Financial Services Action Plan (FSAP) launched by the EU commission contained a blueprint for a common regulatory framework. It was almost fully implemented at EU level over the 1999-2005 period. Several remarks, however, are in order.

The FSAP is (implicitly) based on the market finance model focusing on securities markets as is prevalent in the Anglo-American world. It is in contrast to the bank finance model which is predominant on the European Continent. The result is

the somewhat uneasy focus on conduct of business aspects that would create barriers to cross-border trading of financial products.

Removing these barriers for market integration purposes may easily conflict with concerns for consumer and investor protection. In this respect the home-member-state-mutual-recognition based approach faces the danger that host countries often invoke common good and other escape clauses to protect their citizens' interests. Cross-border transactions have to conform to host state investor protection, thereby imposing an additional regulatory burden which delays market integration.

To avoid this host country intervention, minimum standards and essential requirements are legislated at the EU level. The host states can no longer invoke the "general good" argument in harmonised fields. Instead of such minimal EU requirements, however, in the financial sector a very elaborate and intrusive EU legislation is emerging. It sounds somewhat paradoxical that, in order to support the preservation of the home country control principle, not much leeway is left in the process to home member state regulation.

It appears that in an enlarging EU the regulatory approach based on minimum harmonization is quickly reaching its limits. As the traditional process of legislative harmonization already proved to be cumbersome in the EU, and in the financial sector moreover is faced with continuous financial integration and increasing complexity of financial transactions, it could only be speeded up thanks to the new so-called Lamfalussy approach.

Contrary to the traditional civil code tradition in Europe to spell out everything in a very detailed way, there was a need for a new kind of legislation that limits itself to a limited set of core principles. The legislative procedures by the EU Council and EU Parliament are maintained only for the first line legislation of the high level principles.

At the second level of legislation, the specifications and implementation of these principles are worked out by specialized committees. The translation of these EU Directives into national legislation of the member states is further assisted by level three and level four committees.

These Lamfalussy procedures have led to a coherent regulatory framework for the market place and have also improved the level playing field. The comitology, however, has also contributed to very intrusive legislation at the EU level. As consumer and industry representatives were involved in the comitology process, domestic lobbies sometimes succeeded in maintaining differences in national legislation.

According to Moloney (2003) the FSAP looks much more like a blueprint for an independent regulatory system than a home-member-state-mutual-recognition based integration device, which should produce a regulatory system only as a by-product of minimum harmonisation. The maximum harmonization is also questioned by Wymeersch (2005) as it does not leave much room for regulatory competition, which may be needed for new developments and regulatory innovation. It is also observed that due to certain inherent characteristics of financial markets such as asymmetric information switching cost of clients and importance of branch networks, financial markets will inevitably remain more segmented than many goods markets. Hence the danger of excessive harmonization of regulation for segments of the financial markets for which only modest degrees of integration can be expected (see Mitchell (2005)).

The FSAP is also criticized as an attempt to use law not only to promote market integration, but to redirect financing from the bank-based finance model in Continental Europe to the Anglo-American market finance model. This is achieved by the harmonisation process without addressing explicitly the fundamental question whether the market finance model is the appropriate choice for the EU.

Finally, it may be questioned whether the EU approach of centralised law making is to be preferred over the US approach which relies more on centralised supervision. Centralised supervision may be a more flexible alternative to centralised regulation. The somewhat paradoxical result is that the EU approach, in order to sustain decentralised home member state control, is forced to include in centralised law making detailed directives in order to harmonize the competent supervisory authority structures in the member states. Would an outright supervisory approach, leaving more room for flexibility and innovation, not have been preferable? In the same vein more reliance on competition authorities to open up financial markets could serve as an alternative to harmonization measures for creating a level playing field.

2.3 EU PRUDENTIAL CONCERNS IN SUPERVISION

It is especially in the area of prudential regulation and supervision that the extension of the mutual-recognition-home-country-control-approach to the financial sector raises many issues. First, EU financial market integration may create cross-border prudential risks. Second, cross-border prudential supervision may be difficult to organize in an effective way.

2.3.1 EVOLUTION OF PRUDENTIAL RISKS IN THE EU

Effect of the Single Financial Services Market

The integration of financial markets and the introduction of a single currency confront the financial institutions and markets in Europe with important challenges: when they on balance may not aggregate the fragility of financial intermediaries, they,

however, may well potentially increase contagion risk within the Euro-wide market. The integration of financial markets makes the financial system more resilient to local asymmetric disturbances, and may have beneficial effects on liquidity risk and credit risk. Deeper and more liquid financial markets reduce the likelihood of liquidity problems. The ongoing shift from a bank-oriented to a market-oriented system makes banks less dependent upon the fractional reserve system as a source of fragility. As the proportion of commercial loans is slowly declining, while investments in market securities are increasing, also the typical asymmetry in asset-liability structure is slowly diminishing. The effect of the Euro-wide financial market on market risks however is more mixed. An important source of market risk, i.e. exchange rate movements cannot occur anymore within the Euro-area, contributing to overall-stability. The shift, however, to a market-oriented system makes banks more vulnerable to interest rate risk and asset price risk in financial markets. They also present more opportunities for excessive risk taking due to (collective) moral hazard problems.

The links between European financial intermediaries, however, have become stronger increasing contagion risk and the risk for a EU wide systemic crisis. The financial system contains powerful propagation mechanisms that can amplify small initial shocks. They are transferred throughout the financial system through failures in the settlement of payments, through panic runs on banks by depositors, through falling asset prices or markets that fail to clear when large volumes of assets are liquidating simultaneously (see Berger e.a. (2000)). A European wide financial market relying on a single currency may affect these contagion risks.

The traditional mechanisms of runs by depositors on banks in trouble disrupting the payments system, may no longer apply in a world where depositors benefit from deposit insurance. They are also mitigated by the gradual change towards market-based systems in Europe. As a result contagion is more likely to occur at the wholesale level, in particular through the interbank market. Greater reliance on interbank financing decreases the probability of individual bank failure, but increases the probability of total collapse. More generally, increasing integration and linkages of financial markets in Europe facilitate the transmission of problems in one segment of the Euro-wide market and enhance contagion effects.

Within the EMU national interbank market local currencies have been replaced by an integrated and deep Euro interbank market. As the number of counterparts is larger with more scope for diversification, the interbank market has become less fragile. Cross-border activity and the risk for cross-border contagion, however, have increased. It is mainly in smaller countries that banks operate cross-border, whereas in larger countries the interbank claims and deposits are oriented towards the domestic market (see Schoenmaker and Oosterloo (2004)).

Whatsoever, overall cross-border transactions are increasing in the EU money markets reducing the likelihood of national liquidity failures, but exposing

banks increasingly to shocks originating beyond their national borders. It increases the threat for national disturbances having Euro-wide effects.

Effects of Consolidation

Increasing competition in a European-wide market threatens the profitability and survival of smaller financial institutions. These problems are generally taken care-off by financial consolidation without necessarily disrupting the stability of the financial system. However, does the consolidation often into large complex financial institutions not itself present a danger for systemic stability?

The net impact of consolidation on the risks of individual financial institutions may not be clear, but the negative externalities due to contagion risks may increase.

At the individual level large financial institutions are better able to diversify both earnings and risk. Diversification gains through cross-sector and cross-border activities within large consolidated firms and conglomerates add to stability. On the other hand, the increase in size may also induce a greater appetite for risk and enhance the probability of insolvency.

At the aggregate level, a crisis in one business segment may contaminate other business lines. Also by their sheer size, large financial institutions present systemic risk ramifications. Hence, consolidation creates more financial institutions whose failure could pose a systemic risk to the financial sector. It acerbates also the too-big-too fail problem of moral hazard for fear that failure of such a large firm would be disorderly.

Traditionally, systemic risks find their origin predominantly in banking problems, occasionally also in the failure of investment firms, and less in difficulties in the insurance sector. The cross-sector blurring of distinctions within financial conglomerates e.g. combining banking, insurance and securities activities, however, creates additional sources of contagion. Also the shift towards off-balance sheet activities exposes them more to financial markets, increasing the impact of adverse shocks.

Cross-border activities by large banking groups may lead to particular cross-border externalities. When such an institution fails, its financial problems spread across borders to its foreign branches and subsidiaries. In particular in Central and Eastern European countries where the financial system is dominated by foreign groups, the consequences may be serious.

Schoenmaker and Oosterloo (2005) find that overall cross-border penetration

in the EU is relatively low, but gradually increasing. For an increasing number of large banking groups, however cross-border bank integration has become substantial. Critical prudential problems may arise when they may have a large market share becoming systematically important in a host country, whereas from the point of view of the home country this represents only a small share in the total bank portfolio.

2.3.2 EU FINANCIAL STABILITY: CHALLENGES FOR PRUDENTIAL SUPERVISION

Continuing financial integration increases the potential for financial risks to become cross-border in nature and to have even EU wide financial stability implications. Contrary to monetary policy, however, which is attributed to a European Central bank, prudential supervision of the financial system remains the domain of the national member states authorities.

The problem is further complicated due to conflicting assignments of supervisory powers to home and host country authorities.

First, as an extension of the mutual-recognition-home-country-control principle micro-prudential supervision of the soundness of financial institutions is assigned to the home country for branches of cross-border operating institutions. For subsidiaries, however, control remains with the host country in which it operates. As cross-border banking increases, it entails problems of information, of conflicting incentives, and of coordination between a plethora of supervisors in home and host countries. For the institutions involved it leads to uncertainty and swelling compliance costs. Moreover, as large European-wide banking groups are increasingly developing a single strategy for the whole European market, thereby centralizing business and risk management functions, the distinction between legal and operational structure is increasingly misaligned.

In this respect the differential treatment of branches and subsidiaries is to be questioned. For subsidiaries the host authorities are responsible, but home supervisors will also have to look at the subsidiary and the parent bank on a consolidated basis. Hence would it not be logical to extend home state supervision to all activities and all foreign subsidiaries of the group (see Wymeersch (2005))? For banks within the Basle II framework it certainly would simplify the approval procedures for the validation of the internal rating based risk models. Still the problem remains that for monitoring these risks it requires access to information that is outside the jurisdiction of the home state supervisor. There also remains the issue of suboptimal incentives for the home state to monitor foreign subsidiaries and branches. This may become a real problem if it concerns major subsidiaries or branches with an important market share in the host state creating a political risk. A certain involvement of the local supervisor should also be guaranteed as long as deposit insurance remains a host country duty awaiting further harmonisation at the EU level.

Secondly, potential conflicts are exacerbated by the assignment of the macro-responsibility for financial stability to the host country. The host authorities, however, have not to interfere with the micro-supervision of foreign-owned branches, except in emergency situations. Foreign branches, however, being relatively unimportant for the supervising home country, may acquire a large market share in the host country and hence become systematically important to the host country. An agency incentive problem arises as the home supervisor, who is bearing the costs with the benefits being for the host country, will have suboptimal incentives for efficient micro-supervision abroad. This shows the asymmetry in responsibility between the home and host country supervisor. The home country overlooks the subsidiary in the context of the entire institution; the host supervisor takes only the subsidiary itself in account. This problem especially pops up in the new EU member states where foreign credit institutions possess often more than half of the total assets (see Schoenmaker and Oosterloo (2005)).

In emergency situations central banks traditionally also act as lender of last resort to provide liquidity to financial institutions in need. Whereas the European central bank is entrusted with the conduct of monetary policy, it has no such bail-out authority. This is left to the central banks of the host states. The ECB can only act in an advisory and coordinating capacity in the prudential supervision of banks. It amounts to a rather unique situation in which central banks of the member states are responsible for providing emergency liquidity assistance, but have no direct monetary policy responsibilities.

This ambiguous set-up raises questions as to the effectiveness to deal with systemic risk as well as to further level playing field implications in a single European market. Are national authorities that are involved, capable of assisting in cross-border systemic risks when internationally operating financial firms are involved? Can it in these circumstances be left to the national central banks to take the responsibility of dealing with emergency liquidity assistance? The home country will have few incentives to take cross-border externalities into account when it is faced with decisions whether or not to bail out financial institutions. Conflicts are certainly bound to arise when locally operating branches are more systematically important to the host country than to the home country (see Walkner (2005)). It becomes even more difficult in the event of crisis management and the use of tax money to bail out financial institutions in distress. Free riding behaviour and improvised cooperation between home and host countries leads to an undersupply of bail-outs.

Uncoordinated action may also entail distortions to fair competition in a single European market. To limit potential contagion effects of financial institutions in trouble, preference is to be given to orchestrate private sector solutions i.e. by organizing take-overs. When these actions lead to more concentration, they may conflict with competition policy. Providing public money in extreme cases to troubled institutions may also distort the level playing field within a single market in Europe.

To meet these supervisory challenges the EU already has taken some actions in certain areas. The focus is on supervisory cooperation. Several committees within the Lamfalussy comitology framework are contributing to developing a pan-European supervisory culture in the different domains. The Committee for European Securities Regulators (CESR) aims at establishing a network of EU securities regulators. At the banking level, the Committee for European Banking Supervisors (CEBS) is fostering convergence in regulatory practices and establishing networking between authorities. In particular the harmonisation of reporting requirements for banks in order to harmonize information collection across countries should help to lower the costs of cross-border supervision. For the insurance business the Committee for European Insurance and Pension Supervisors (CEIOPS) is still concentrating on the initial legislative stages in this domain.

At the legislative level, the new Capital Requirements Directive within the Basle II framework for banks entrusts the “consolidating supervisor” with coordinating responsibilities regarding banking groups with foreign subsidiaries. The directive for financial conglomerates refers the supplementary supervision of mixed banking and insurance groups to a “coordinating supervisor”.

In order to deal with the decentralisation and segmentation of financial stability functions, a number of committees at the EU level are involved in organizing cooperation between national authorities. For crisis situations Memoranda of Understanding (MOU) provide in EU wide cooperation between authorities. They are, however, of a voluntary nature and are non-legally binding.

On the whole there remains a gap between micro- and macro-prudential controls. The financial market surveillance by (host country) central banks is still in need of better coordination with the micro-prudential responsibilities of (home country) supervisors. As EU coordination is only gradually progressing, the need to put in place institutional arrangements for managing crises of cross-border banks in Europe remains an urgent concern.

2.4 THE CLEARING AND SETTLEMENT INDUSTRY

The European Commission describes the clearing and settlement industry as the “plumbing of the financial markets: largely invisible, seldom understood and frequently overlooked but causing really unpleasant problems if it goes wrong” (European Parliament (2005)). According to the Bank for International Settlements (BIS (2006)), the total value of the transactions in large-value payment systems and securities settlement systems is the equivalent of annual GDP turned over in a few days. The securities settlement has a big importance in Belgium, because the ICSD Euroclear Bank is registered as a Belgian company and supervised by the Belgian authorities. The total amount of transactions in Belgium was valued at 198,000 billion dollar in 2005, which makes that Belgium has the biggest securities settlement industry

in Europe, after France. As will be shown further on, weaknesses in the securities settlement system can cause huge systemic distortions to securities markets and other settlement systems.

Recently, the securities and safekeeping industry caught the attention of both academics and policy makers. The reports by the European Commission and the Giovannini Group are only a few of the recent publications. While those publications mainly addressed efficiency issues, there are also prudential risk issues at stake.

Participants in the settlement industry face many different risks. Among others, the Committee on Payment and Settlement Systems (CPSS) highlights the legal risk (ill-founded legal framework) credit risk (the transaction is not settled), liquidity risk (the transaction is settled, but too late), principal risk (security is delivered, but payment is not received or vice versa). He also mentions mistakes or shortcomings in the system, controls or procedures (operational risk), or in the safekeeping of securities (custody risk). Apart from the custody risk, the underlying risks in the settlement are similar to those of other financial institutions.

In their survey on systemic risk, De Bandt and Hartmann (2002) discuss the systemic risk in the payment and securities settlement. The fundamental difference between the payment settlement systems and the securities settlement system is that securities transactions are based on “two legs”: the delivery of the security and the payment of the fund. This also means that a potential crisis can less easily be solved. Whereas in the payment settlement, the provision of cash can solve the problem; it can not in the securities settlement. After all, the provision of cash only affects the cash side of the transaction, not the securities side (see Devriese and Mitchell (2005)).

The need for oversight can be explained by the potential market failures in the payment and settlement systems (CPSS (2005)). The CPSS argues that many systems function safely and efficiently without the intervention by regulators. But in some cases, there is a role for the public sector: mitigating the potential market failures. The CPSS discovers three failures: negative externalities that cause systemic risk, coordination problems and market concentration.

Systemic risk. They argue that, without intervention, there can be too much risk. One explanation is that economic agents do not fully internalize all of the costs linked to their actions. When agents cannot meet their obligations, they are not aware of the problems that it may cause: for example in the settlement system, a failure of one party can lead to an unwinding process. It means that all the transactions that are done after the failing transaction have to be deleted. Freedman and Goodlet (1996) point out that the unwinding procedure is highly unacceptable. It is very disruptive, does not eliminate systemic risk and does not exclude significant liquidity and credit risk after unwinding.

Coordination problems. Another type of externality is due to the network property of the settlement system. In order to realize the network benefits, coordination between the multiple institutions may be needed. This can prove to be difficult if some of the institutions will not bear the coordination cost and free-ride. For example, to introduce common standards, public intervention may be advisable.

Market concentration. In last years, the clearing and settlement industry went through a consolidation wave. As shown by Van Cayseele and Wuyts (2006a, 2006b), there clearly are economies of scale and scope involved. This means that the most efficient market structure may probably be a natural monopoly or only a few providers. This raises concerns about the potential market power and abuse of dominant positions. It also leads to high dependency on a few systems, without ready available alternatives. One of the key points in the concentration discussion is the contestability of the monopoly. Van Cayseele (2004) argues that a contestable monopoly may outperform a heavily regulated system.

As the need for supervision is clear, it is less clear how the supervision should be organized. CPSS proposes some general principles on securities settlement oversight by central banks. These principles are mostly accepted and followed by these central banks. On the oversight of multinational settlement systems, the idea of a central bank with primary responsibility is developed. According to the CPSS, there should be a presumption that the central bank where the system is located will have this primary responsibility. However, there remains some flexibility. It could be agreed that another central bank or authority will have the primary responsibility.

In Belgium, the Banking, Finance and Insurance Commission (CBFA) and the national bank are jointly responsible for the supervision of the securities settlement and safekeeping. The Banking, Finance and Insurance Commission is responsible for the prudential supervision, whereas the national bank is put in charge for the oversight tasks. In practice, they cooperate in the supervision of Euroclear and LCH.Clearnet. For Euroclear, the National Bank of Belgium (NBB) is the lead supervisor; for LCH.Clearnet, the NBB participates in the international coordinated supervision, but is not the lead supervisor.

To conclude, the recent attention of the European Commission and the European Central Bank (see section 3.2) should not surprise. A really integrated European financial market cannot be achieved without a more integrated post-trade market. However, not only efficiency considerations are at stake, but also soundness concerns are important to determine the structure of the post-trading industry.

3. WHAT EUROPEAN AGENDA?

The issues mentioned in the previous sections made it abundantly clear that there is still enough work ahead in European supervisory matters. Not so much work remains to be done on the regulation side – maybe there is already too much regulation – but rather on the organization of prudential supervision. The main question is how supervision should be organized when financial institutions cover different countries or different sectors.

3.1 FINANCIAL REGULATION

The Lamfalussy process has been successful in reforming financial market regulation in a consensual and rapid way. However, no complacency is in order as the system will only be tested as a financial crisis would strike the EU (see Lannoo and Casey (2005)).

To a certain extent, the new legislative approach has been the victim of its own success as it resulted in very detailed regulation of an intrusive nature, especially in the area of securities market and banking regulation. The maximum instead of minimum harmonization at the EU level for fear of downward regulatory competition (race to the bottom), has met the limits of the traditional mutual recognition system.

A regulatory pause has been called for. Still the regulatory process is continuing as e.g. with new directives in the area of insurance business. As some competition in regulation may be in order in a dynamic and innovative financial market, the recent 26th regime proposal to install parallel regulation for simple insurance and saving products, applicable to those operations and consumers who want to be active across borders, may be worth exploring. Also the non-regulatory initiatives to establish a voluntary code of conduct to eliminate sources of inefficiencies in cross-border activities for the clearing and settlement industry, could potentially act as a model for interaction in other areas of the financial sector. Similarly, activation of competition policy by the competition authorities could present an alternative for regulatory intervention.

Other initiatives may be in order as the European continental legislative structures present an inherent tendency towards regulatory overkill. According to Lannoo and Casey (2005), excessive detail in level 1 legislation must be avoided by developing a “levels test” to what constitutes framework principle. The proposed test makes a clear distinction between objectives of a proposal and the means to achieving them. It is argued that the objectives should be defined at level 1, whereas the means should be discussed at level 2. The authors claim that the levels test of the MiFID guideline shows that this directive contains too much details entering at level 1. The quality of regulation may also be enhanced by a broader use of regulatory impact analysis (RIA).

3.2 THE CLEARING AND SETTLEMENT INDUSTRY

In 2002, the Eurosystem came up with the proposal of TARGET2-securities, or TS2 in short, a new settlement platform for securities transactions. If TS2 is implemented, it will have a huge impact on the settlement infrastructure. Besides concerns of ownership, governance and operational issues, TS2 also raises questions of accountability and prudential supervision.

Different studies mark the European settlement industry as fragmented and inefficient (for an overview, see European Commission (2006)). Although the numbers differ across the studies, all studies show that the settlement in the United States is more efficient than in Europe especially when it comes to cross-border settlement. As argued by Van Cayseele and Wuyts (2006b), there is, even after the recent consolidation wave, still room for cost savings through further consolidation.

But according to the European Central Bank, further consolidation is not the best way to achieve more efficiency. Their proposal is to implement a unique platform for securities transactions, as exists now already for payments settlement, made operational by the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET). In this system, the CSD remains the access point for investors to settlement services, but the operational part is done by TS2. According to a study of the ECB, TS2 can lead to a cost reduction up to 90%, although the study is heavily questioned by the European Central Securities Depositories Association (ECSDA). The system can be operational in 2013, but feasibility studies are on their way.

The ECB prefers the implementation of TS2 above further consolidation. They argue that a consolidation takes time and can be painful for the absorbed CSD. By cooperation with the CSD, ECB hopes to achieve integration faster and less painful and hopes to promote competition at the same time.

TS2 is supported by the banks, but the European finance ministers and the ECSDA remain critical. They claim that the ECB should not proceed with the implementation of TS2 before questions on governance, ownership and operation are handled. The European Council of Finance Ministers (EcoFin) expressed concerns about the creation of a monopoly platform. The biggest problem is the accountability. Whereas the national CSDs oversight happens through the national supervisors, it is not clear who should supervise TS2. Willem Buiter of London School of Economics notes that the high degree of operational independence and the absence of substantive accountability might be desirable and necessary for monetary policy, but it is certainly not for the manager of the securities settlement and clearing system³.

3.3 PRUDENTIAL SUPERVISION

The main concern is the adequate implementation and enforcement of the new European financial regulation. This, however, is inevitably linked to the complexity of the present financial supervisory structure. Whereas EU policy-makers tend to favour a gradual evolution, the question arises whether a more fundamental reshuffling of the supervisory architecture is not in order.

The proposals made by policy-makers are mostly limited to “supervisory convergence”. It comprises the consistent implementation and enforcement of the rules, in which the level 3 supervisory committees could play a crucial role. However, as there are important differences in competences of the supervisory authorities, also more convergence in their organizations may be needed. It also has been argued that supervision for pan-European banking groups should be underpinned by the adoption of a single rulebook framework across the EU by the level 2 regulatory committee.

These are necessary but not sufficient conditions for cooperation that is to be further strengthened in supervising cross-border financial business. Progress in this area reveals to be difficult as national supervisors may face a collective action problem. All countries may be better off by cooperating, but each country believes it can gain by operating alone.

Especially in the area of crisis management cooperation remains an issue. Whereas structures for liquidity crises have been largely secured, the EU framework for burden sharing in case of solvency crises with cross-border effects is still incomplete. It is suggested that the finance ministries should be better included with the MOUs (see Lannoo and Casey (2005)).

In defence of the present decentralized and evolutionary approach it is sometimes argued that it preserves a sufficient level of supervisory competition. It is left to the market to shape the structure of supervision. In the longer terms, it will lead to some consolidation in financial supervision in the EU. The market for supervision will eventually give rise to a two-tier structure. A number of important supervisors will emerge in the financial centres where most of the headquarters of larger financial firms will locate. Smaller countries will remain in charge of local institutions and some other specialized intermediaries (see Wymeersch (2005)).

3 High degree of ECB independence in securities sector is undesirable, Willem H. Buiters, *Financial Times*, January 19, 2007.

Policy-makers tend to adopt a wait and see attitude, and argue that the need for further European arrangements depends on the evolution of cross-border business and the intensity of cross-border spill-over effects of national supervision. Smaller regional European financial institutions (operating in one or more neighbouring countries) can still be handled by coordinated decision making to be enhanced through MOUs covering supervision and crisis management. Only when truly pan-European institutions emerge, there would be a need for broader institutional European solutions (see Schoemaker and Oosterloo (2005)).

Within the financial industry, however, there is a progressive divergence between operational and legal institutions as they are centralizing risk management and no longer organizing according to geographical lines. For cross-border banks the business lines cut across national frontiers. This rapid internationalization of operations among financial intermediaries, contrasts with the rather static and national-based EU supervisory structures.

To deal with the split between home and host country supervision, one solution would be to introduce a “lead supervisor” responsible for prudential supervision of all group entities. He would also coordinate and make final decisions when emergency liquidity assistance is needed or crises management situations arise. These tasks would go beyond the present tasks of the consolidating supervisor or the coordinating supervisor for financial conglomerates. The difficulty however is that it would involve a transfer of sovereignty which would be difficult to accept by host supervisors as they may point to the diverging incentive structures to coordinate spill-over effects. Moreover, would it not also imply the need for a lead central bank and a lead financial ministry in case of crisis management?

The problem of spill-over effects could be overcome by involving a European authority. Centralized supervision would increase efficiency which however may come at cost of flexibility in applying still different regulations to countries with various financial systems. Hartmann, Manganello and Monnet (2004) therefore argue that the benefits of a single regulatory and supervisory framework crucially depend on the symmetry in the financial systems of the EU member states.

The European authority, however, should not necessarily be constituted as a centralized institution but could be organized as a European System of Financial Supervisors. Similarly to the European system of Central Banks, the central decision making bodies are the one based on the participation of the pre-existing national bodies who would be in charge of implementing the centrally defined policies.

Some authors (see Di Giorgio and Di Noia (2003)) argue that this system should no longer be set up according to traditional sectoral lines distinguishing between banks, insurance companies and securities/investment firms. The vertical

institution oriented architecture of supervision should be replaced by a horizontal objective driven supervisory set up. The achievement of the three objectives of fair conduct of business, micro-prudential supervision of solvency and macro-prudential supervision of systemic risk should be the task of separate supervisory authority in each country. At the European level, each division would be coordinated within a European system: a European system for financial market transparency, a European system for micro-prudential supervision of solvency and a European system for macro-prudential supervision of systemic risks. Such a structure would clearly allocate responsibility for each objective to a specialist supervisor having a comparative advantage in information and monitoring. It could also better deal with cross-sectoral matters within financial conglomerates. Still it may increase compliance costs as each financial intermediary would have to be supervised by three separate financial supervisors. It also raises issues of coordination in supervision among the different systems.

Whatsoever, as the whole regulatory framework relies upon a distinction between securities markets, banking and insurance business, it appears more realistic to maintain this structure in the supervisory architecture.

For securities market transactions, a SECType European Institute could be envisaged, as Stock Exchanges are integrating across countries and eventually no domestically oriented exchange will be left. Recent proposals with respect to the adoption of a qualified majority with the CESR⁴ in certain fields of the securities business go in that direction. Eventually it would put the Committee on track of an EU supervisory body (see Wymeersch (2005)).

The picture is somewhat different in the field of supervision of banks. Many financial intermediaries operate mainly domestically alongside with internationally operating financial conglomerates. The enlarged EU comprises about 8,800 credit institutions, very little of them have a significant cross-border banking business, and about 40 large financial groups operate in five to six member states. The latter, however, represent a fairly significant share in the total banking business. For most of the banks, adequate supervision may take place at the national level complemented with MOUs for cross border aspects. For the large financial conglomerates, however, micro-prudential supervision cannot be efficiently conducted on national basis. Moreover, European-wide systemic risks are involved. The borderline between micro-prudential and macro-prudential supervision becomes very diffuse for them.

4 See CESR Himalaya consultative paper

In the US it has led to a multi-tier structure for financial supervision (see Fase and Van Thoor (2000)). Large banks chartered by the federal government are supervised by the board of governors of the federal system. State member banks are supervised by the different reserve banks of the federal systems. The other financial institutions are still supervised by other institutions such as the federal deposit insurance corporation, the Office of Thrift supervision etc. In the long run, however, supervision is moving in the direction of more centralization.

Can such a model, in which national supervisors function alongside with a European supervisor, not be envisaged for the EU?

To answer the question, one may look into the example of the organization of competition policy in the EU. Merger control is undertaken by the EU Commission or referred to member states according to the one stop shop principle. Mergers are subject to the control of the EU Commission when they have a community dimension. The distinction is made on the basis of the magnitude of the investigated cases according to very specific quantitative criteria.

A similar two-tier structure may be envisaged for prudential supervision (see Oosterloo and Schoenmaker (2005)). For the smaller, mainly nationally operating financial intermediaries externalities are unimportant; agency problems due to informational asymmetries can be better solved by national authorities being closer to the relevant market. For large financial conglomerates, however, externalities tend to be large and there may be economies of scale in information gathering. When principals have conflicting objectives, the agent will try to give different signals to each principal leading to an inefficient outcome (see Smets and Van Cayseele (1996)). Supervision by one principal at the EU level may reveal to be more efficient. Contrary to the one stop shop principle, however, it needs not to result in outright centralization. According to the distinction between real and formal authority, also national supervisors may continue to be involved in the supervision of the conglomerates, but a leading coordinating role should be developed at the EU level.

Whereas national central banks may be involved in the supervision at the national level, it is less obvious to give the same formal policy power to the European Central Bank. The supervision of individual intermediaries would imply accountability, also tax money would be at stake in case of crisis management, threatening the independence of the European Central Bank. Also the functional integration between banking, securities activities and insurance may suggest a more autonomous coordinating supervisory authority at the EU level. Rather than being directly involved in the prudential supervision of the solvency of individual institutions, the ECB should focus on the macro management of financial stability. Eventually, a solution could be found in giving more autonomy to the Banking Supervisory Committee.

3.4 MORE FUNDAMENTAL RESEARCH AHEAD

Whatsoever the gradual improvements of the institutional arrangements and notions of more radical changes to the current EU supervisory structure, substantial preparatory work is still needed.

This should be based first on a better assessment of the need for financial regulation and supervision. Market discipline is increasingly seen in an integrating world as an alternative to externally imposed regulation and supervision. In a recent report it is stated that the ability of the market to come up with credible forms of self-regulation will determine its future. Also the regulatory burden on financial operations and its effect on the competitiveness of EU Financial services firms should be taken into account. More attention should go to the accountability of financial regulators as they may also be liable to principal-agent distortions (see Schüler (2003)). Moreover, financial regulation should be better related to other complementary policy areas such as corporate law and governance reforms, accounting and statutory auditing, etc. (see Lannoo and Casey (2005)).

Secondly, more research is needed in the area of multilevel regulation and supervision. Traditionally the subsidiarity principle dictates the assignment of regulatory functions to the lowest level of government where the function can efficiently be taken care off. Smaller jurisdictions are more homogenous in their preferences and lower level governments have better information on these preference structures (see Van Rompuy, Abraham and Heremans (1991)).

This assignment no longer holds when spill-over effects of policies of one government level on other government levels become important. These externalities however, have in first instance to be solved by cooperation. Only when coordination costs are high, or for policies where economies of scale are predominant, will the involvement of higher level government increase efficiency. In this respect, spill-over effects may differ among the area of securities, banking and insurance business.

For the issues at hand, scale economies are precisely an important driving force towards financial market integration in the EU. In the process, externalities with respect to level playing field implications and international spill-over of financial fragility are increasing. Hence, it is the expanding market size that should determine the locus of regulation. Moreover, in the EU a more efficient market size, i.e. a European wide single financial market, has become a policy-goal in itself. Should the locus of regulation not be adjusted accordingly as differences in financial regulation among member countries act as barriers to the free movement of financial services?

This reasoning goes beyond the traditional argument that only in the longer run, as integration proceeds, more far reaching institutional adaptations at the

EU level will be required. The actual state of financial market integration is not the appropriate criterion to determine the locus of regulation and the need of European action, as precisely a reassessment of regulatory functions may impact on the process of financial market integration (see Heremans (1999)).

These normative principles of federalism, however, have to be further translated taking into account managerial problems of how to design an efficient organization in what may be called a political theory of federalism. It has to take into account that the information sets and incentives of various government levels may differ. This creates agency problems, which have to be further explored. According to this analytical framework, a supra-national system may be set up with the lower authority having real authority, as it may most of the time decide effectively due to informational advantages, without having formal authority as the central authority can ultimately reverse the decision (see Aghion and Tirole (1997)). In this context, also competition in regulation and supervision, may be important as an accountability and sanctioning device.

Finally, further analysis of the legal systems in a law and economics approach maybe in order, as it has determined the evolution towards the internal market legislative approach in the EU. The supervisory approach in the US is less legislation oriented and is more flexible as it functions mainly through policy-making by the supervisory authorities. The more flexible common law system facilitates inter-agency coordination between the various authorities. Civil code systems are more rigid as they spell out in a very detailed way what each specific government agency may and may not do and therefore are less suited for coordination. The paradox, however, is that the European mutual-recognition-home-country-control-approach maintaining a plethora of national supervisors, very much relies upon such a coordination. Common law systems are more flexible in allowing institutions to adapt to changing economic and financial conditions (see Goodhart (2000)). Moreover, it appears that the EU legal approach faces particular difficulties in dealing with financial regulation, as in the field of finance, European continental legal systems lack the multitude of workable legal concepts that characterize Anglo-American law (see Heremans and Cousy (1996)).

4. CONCLUDING REMARKS

The financial services action plan (FSAP) aiming at an EU wide financial market turns out to be overly ambitious in its legislative approach. The traditional home-member state mutual recognition based integration device, which has been successful for product markets, presents more problems for the information-intensive financial products and services.

A rather coherent regulatory framework for the EU financial market place is being achieved by the Lamfalussy procedures, however at the price of maximum harmonization and very detailed and intrusive regulation.

At the same time, increasing cross-border activities within the EU single financial market are challenging the prudential framework. Supervisory duties to safeguard the soundness of financial institutions and the stability of the whole financial system remain in the hands of national member state authorities. Legal distinctions such as the assignment of the supervision of branches to home authorities and the supervision of subsidiaries to host states, can no longer be maintained for large financial groups which are increasingly centralizing business and risk management functions. Conflicts among member countries' supervisors are also bound to arise when foreign branches become systematically important for host states, as already may be the case in Central and Eastern European countries. Improvised cooperation with respect to crisis management of financial intermediaries in distress raises very critical issues for overall financial stability in the EU.

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