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Report on Financial Stability

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REPORT ON FINANCIAL STABILITY

I Introduction

At the Informal Ecofin of 11 September 1999 in Turku, ministers and governors agreed to ask the Economic and Financial Committee to check whether the existing regulatory and supervisory structures in the EU can safeguard financial stability, particularly in the context of a rapidly changing financial environment. For this purpose, an ad hoc working group, chaired by the Dutch Deputy Governor Henk Brouwer prepared this report on financial stability under the aegis of the EFC. The organisation of the report is as follows. Section II contains the main conclusions (*assessment*). The rest of the paper examines the impact of the major financial trends on the stability of the financial system in Europe (section III), as well as the arrangements in the EU aimed at safeguarding financial stability. These arrangements can be divided into two main groups: the first one covers regulations (section IV) and supervisory structures (section V), which are primarily directed at *preventing* financial instability. The second group of arrangements consists of various types of *crisis management*, such as liquidity support to individual institutions or to the market as a whole (section VI).

II Assessment

II.1 Financial developments

The report has examined the influence of ongoing financial trends on the existing regulatory and supervisory structures aimed at safeguarding financial stability in Europe. The common element of the financial trends discussed is that the linkages between financial markets and financial institutions, both across-borders and across-sectors, are intensifying. The development of deeper, more liquid and more diverse financial markets contributes to financial stability. At the same time, increasing integration and linkages of financial markets can facilitate the transmission of risks and enhance contagion effects. Furthermore, it may be noted that banks, which still play a pivotal role from a financial stability viewpoint in all European countries, are increasingly influenced by developments on capital markets. However, the process of intensifying linkages is not proceeding at the same pace in all European countries. In addition, the financial trends discussed do not stop at the borders of Europe, as for example the internationalisation of the activities of large European banks involves both non-European and European countries. Consequently, the process of intensifying linkages between and among financial markets and institutions is not particularly a European, but a worldwide phenomenon.

The introduction of the euro has further intensified the linkages between financial markets. An integrated euro money market has emerged and the euro securities markets are deeper and more liquid than those previously existing in the participating countries. Furthermore, the fact that exchange rate movements cannot occur anymore within the euro area also contributes to the overall stability of European financial markets. The establishment of a pan European payment system (TARGET) overseen by the ESCB has been a favourable development in this respect. On the other hand, contagion risks may have increased, since a problem in one segment of the euro-area can have repercussions on the euro area-wide market and beyond. In this respect, it is noteworthy that Euro-denominated markets have developed in non-participating as well as participating countries.

As a result of the introduction of the euro the geographical domain of monetary policy and that of prudential supervision do not coincide anymore. Monetary policy is now conducted at the euro area level, whereas supervision on individual financial institutions and markets has remained the responsibility of national authorities. When there is a major disruption in financial markets, the Eurosystem could make use of its monetary instruments if this is deemed necessary to safeguard financial stability, the smooth functioning of the payment system, or the primary objective of price stability. On the other hand, the national authorities will decide on how to deal with financial difficulties of individual institutions. This is consistent with the responsibility of national authorities, including finance ministries, for operations that may place taxpayers' money at risk. Although financial instability may arise from either market disruption or failing institutions, these sources often coincide in practice. In particular, problems at a large financial institution might have contagion effects on other financial institutions and thereby on the financial system as a whole, and vice versa. It is crucial, therefore, that the national authorities and the ESCB exchange information and cooperate smoothly.

II.2 Institutional arrangements and their practical functioning

With respect to safeguarding financial stability in Europe, it is useful to make a distinction between *institutional* arrangements on the one hand and the ways in which they are put into *practice* on the other hand. The institutional arrangements are based on a framework of legally binding, harmonised directives which are founded upon the principle of mutual recognition of national regulations. This combination creates a single market, in which

financial institutions are supervised by national ‘home country’ supervisory authorities. The relevant directives are adapted to the changing financial environment on the basis of proposals developed by the Commission in co-operation with various cross-border and cross-sector committees, such as the BAC and its counterparts in insurance and securities regulation (the IC and the HLSSC). In this process, the EU ministers of finance, represented in the Ecofin, are jointly responsible for approving the directives, while they are individually responsible – and thus accountable vis-à-vis their national parliaments - for keeping European directives and national regulations in line with each other.

The practical functioning of the institutional framework is firstly constituted by Memoranda of Understanding (MOUs). In particular, MOUs serve to specify the bilateral cross-border co-operation between sectoral supervisors that is obliged in the context of ‘home country control’ and ‘consolidated supervision’. Where large cross-border financial institutions have emerged, cross-sector MOUs have been signed to provide clarity on the supervisor(s) responsible for consolidated supervision. Incidentally, it appears from a survey conducted by the working group that the information exchange and co-operation through MOUs is more elaborate in the banking sector than in the insurance sector.

Secondly, several groups have been established to exchange information and to strengthen the co-operation among supervisors, and between supervisors and national central banks. With regard to banking supervision, the relevant committees are the Groupe de Contact and the Banking Supervision Committee (BSC). The Groupe de Contact is a forum of supervisory experts for the exchange of views on individual institutions and market developments, and the assessment of trends in the banking sector. The BSC has a double mandate from the Governing Council, i.e. (1) to assist the ESCB in contributing to the measures undertaken by the competent authorities in the field of prudential supervision of credit institutions and the stability of the financial system, and (2) to provide a multilateral forum for the exchange of information and co-operation between banking supervisors of different Member States.

The establishment of the ESCB has improved the ability to co-operate, as national central banks that are part of this system are either formally responsible for, or closely involved in, banking supervision. When central bank actions are needed to stabilise financial markets, such as the handling of payment system problems or liquidity shortages in the market, the

ESCB has the instruments to react promptly, under the condition that the primary objective of price stability is not jeopardised.

Several other instruments can be deployed to limit potential contagion effects of financial difficulties at individual institutions. In these circumstances, the national supervisory authorities may orchestrate private sector solutions such as organising take-overs. Also, clear mechanisms and allocation of responsibilities have been established within the ESCB for providing liquidity support to solvent institutions. In extreme cases, national authorities may have to provide public money to troubled institutions.

II.3 Recommendations

The existing *institutional* arrangements provide a coherent and flexible basis for safeguarding financial stability in Europe. No institutional changes are deemed necessary. However, the work underway in the context of the Commission's Action Plan for Financial Services deserves strong support. In particular, it is recommended that EU legislation containing prudential rules for cross-sector groups (i.e. financial conglomerates) be drawn up. In addition, the Commission's request to the Lisbon European Council that an agreement be reached on the proposed directives on the winding-up and liquidation of banks and insurance companies respectively.

As for the *practical functioning* of the institutional arrangements, they do need some enhancement. In order to adapt the practical arrangements further to the prevailing trends in the financial sector, the following policy measures are recommended:

- Strengthening the cross-sector co-operation at the international level, since the present supervisory arrangements are primarily designed to enhance cross-border co-operation. Within the EU, an important development is that the EU Commission has facilitated a round table discussion among the chairs of the supervisory committees of the different disciplines. International cross-sector co-operation could be further improved by clarifying and extending the concept of the co-ordinating supervisor(s) for the large financial groups domiciled in Europe.
- Making the exchange of information among different supervisory authorities, and between supervisory authorities and central banks, on the major financial institutions

and market trends a key feature of the strengthened co-operation between the authorities involved. In this respect, the BSC and the Groupe de Contact can be expected to work in close collaboration. Furthermore, it is important that the ministries of finance and supervisory authorities regularly exchange views on the adequacy and necessary adjustments of financial regulation in a national context as well as in the context of the BAC, the IC and the HLSSC.

- Strengthening the co-operation between supervisors and central banks, with a view to ensure that if the emergence of financial problems at a major group may have contagion effects in other EU-countries, this is reported to the relevant authorities of the countries concerned.
- Working on the convergence of supervisory practices, which can significantly enhance the efficiency of the national supervisory authorities involved in monitoring cross-border financial institutions.

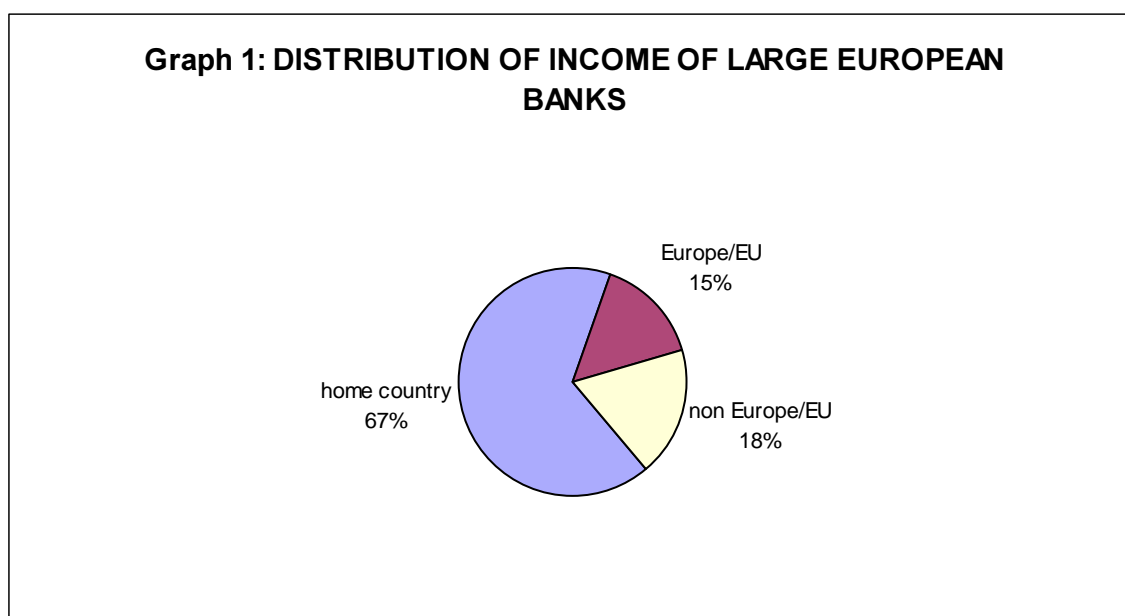
Finally, the working group is of the opinion that future development should be kept under review and that the ministers should be informed by the EFC about these developments on a regular basis.

III Financial trends

III.1 Internationalisation

Mainly as a result of improvements in information technology and deregulation, world financial institutions and markets are experiencing many changes, which could have significant implications for the stability of the financial system. Both information technology and deregulation can be regarded as underlying forces of several developments in the financial system. A trend that is particularly relevant in the context of this report concerns *internationalisation*, as it may result in overlapping responsibilities of different supervisory authorities. Advances in information technology have lowered the costs of communication, making an international network more practical, while at the same time deregulation has opened up new markets. These factors have facilitated the process of internationalisation, which may have gone further in some regions than in other ones.

Assessing the degree of internationalisation is a difficult task, and the measures used in the literature should be interpreted with caution. The *proliferation of establishments* of foreign credit institutions is a traditional measure for the degree of cross border activity. The market share of foreign branches and subsidiaries established by credit institutions domiciled in other EU countries is currently relatively small, with the exception of Belgium, Ireland and Luxembourg. Establishments of credit institutions outside the EU account for an even smaller portion of activity. *Cross border mergers and acquisitions* – another measure of penetration in foreign markets – have thus far not taken place in the EU on a large scale (see also section III.3), although there exist some regional differences. The *geographical distribution of banks' earnings* sheds a different light on the degree of internationalisation. This indicator is somewhat broader than the previous ones, since, for example, off-balance-sheet activities are taken into account. It follows that a substantial part of the earnings of the *largest European banks* come from abroad (see graph 1) ¹.

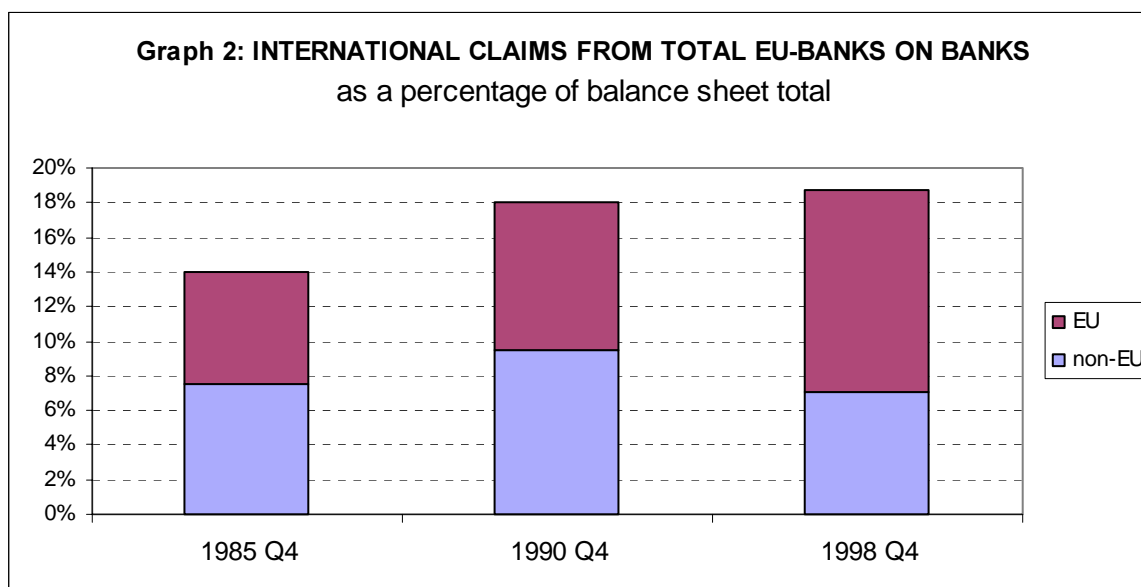


Source: Annual reports of individual credit institutions that are part of the Europe top 50 of The Banker, based on total assets end 1998

More than half of this foreign income is earned in countries outside the EU. For the purpose of evaluating the risks for cross border contagion it is, however, also relevant to investigate

¹ In general, income consists of the following items: interest income, income from shares, commission income, profit from financial transactions and other operating income

interbank claims of EU banks.² BIS-data indicate that the international interbank claims of EU banks, measured as a percentage of total assets, have grown markedly from 1985 onwards (see graph 2). Furthermore, the links between banks of the EU have also become stronger. (For example, in the fourth quarter of 1998 international claims from banks located in the EU, on banks located outside the EU, cover 7 per cent of the balance sheet total of the EU banking system. International claims from banks located in the EU, on banks located in the EU, cover 12 per cent of the balance sheet total of the EU banking system.)



Source: BIS Databank (block M), International Banking Statistics. For Greece and Portugal no data were available in the BIS Databank. Balance sheet totals are taken from the OECD Banking Profitability and are dated end 1997.

These measures point to the conclusion that in nearly all EU-countries the bulk of traditional activity still maintains a predominantly national dimension, and that the repercussions of failures would therefore be mainly felt by domestic counterparts. However, the international interbank claims of EU banks have gained in importance, and particularly the largest banks in Europe appear to be increasingly exposed to shocks originating beyond national borders, which potentially adds to systemic risk.

III.2 Introduction of the euro

Before discussing other trends, it is important to make a distinction between the countries that make up the EU and the ones of the euro-area. In the EU, the establishment of the

² Claims on banks = total assets -/- non-bank assets

harmonised regulatory framework and the liberalisation of capital markets provided the basis for a single market for financial services. As a result of the introduction of the euro the geographical domain of monetary policy and that of prudential supervision do not coincide anymore: monetary policy is now conducted at the euro area level, whereas supervision on individual financial institutions has remained the responsibility of national authorities. As far as ESCB monetary policy operations are concerned it is important to note that the general eligibility criteria for counterparty status are uniform throughout the euro area, and that the ECB may reject or restrict counterparties' access to monetary policy instruments and/or to the payment system TARGET on grounds of prudence. It is also of relevance that the assets used as collateral have to fulfil certain criteria in order to be eligible for ESCB monetary policy operations.

An integrated money market has emerged in the euro area, and the merger of national large value payment systems within TARGET has facilitated the redistribution of liquidity across the borders. As far as capital markets are concerned, the effects of the euro are also substantial, as euro securities markets are deeper and more liquid than those previously in the participating countries. Furthermore, the fact that exchange rate movements and related movements in interest rates can not occur anymore within the euro-area has contributed significantly to the overall stability of European financial markets. On the other hand, contagion risks have potentially increased, because a problem in one segment within the euro-area can be expected to have repercussions on the euro area-wide market. Furthermore, in the medium and long run, the euro could act as a catalyst to reinforce prevailing trends such as internationalisation, as well as other trends that are discussed below.

III.3 Other trends and changes

Technological progress and deregulation have resulted in many *new financial products* that allow the various risks which are implicit in a financial product to be unbundled and traded separately. In this context, the strong growth in derivatives should be mentioned. In general, this development has contributed to the efficiency of global financial markets, as derivatives may allow for a reallocation of risks. The growth of derivatives has also created opportunities to increase leverage for certain institutions in the financial sector, such as hedge funds. Many changes in financial markets, most notably the rapidly increasing supply of financial services through the Internet, may result in enhanced competition at the national and international level both between banks and other institutions. These changes could

increase the vulnerabilities of individual firms, as well as the risk of contagion between market participants that are leveraged in the same way, and the systemic risks in general. A related trend is *disintermediation*. Against the background of deregulated capital markets, which are becoming more transparent and liquid, firms raise capital directly in the market instead of obtaining loans from banks. In practice, banks are not playing a less important role in the financial sector, but they focus nowadays increasingly on other activities, such as investment banking, trade in securities and derivatives, leasing, and other off-balance activities. As a consequence, the current financial system, which used to be essentially bank-based, is gradually shifting to a more market based system. As banks' assets have become more liquid and marketable, one implication could be that the likelihood of liquidity problems is reduced. On the other hand, banks' exposures to changes in market developments could also be higher, making market reactions an important channel for spreading financial problems.

As many other banking systems, a trend towards *consolidation* characterises the European banking sector in recent years. Until now, most mergers and acquisitions have taken place within the national borders, although cross-border consolidation is gaining importance. An example is the recently announced merger of MeritaNordbanken, which operates in Sweden and in Finland, with Unidanmark, which operates in Denmark but has an insurance subsidiary in Norway. The trend towards consolidation has several implications for financial stability. Efforts to improve product and geographical diversification could make banks more resistant to local or national business cycles, adding to financial stability. These diversification gains can, however, to some degree be neutralised by increasing operational risks that may arise as a result of consolidation practices. In addition, consolidation may lead to more financial institutions whose failure could pose systemic risk to the financial system. The problem of moral hazard ("too big to fail") could therefore also increase. A related issue concerns the possible effects of consolidation on *competition*. As consolidation will reduce the number of banks and increase its size, market power may increase and the environment in which banks operate may become less competitive. Not all studies point in this direction though. Taking into account potentially increasing competition from abroad and from non-bank-institutions, the effects of concentration on competition could be partly or wholly counteracted. If that is the case, banks may take more risks.

A final trend to be considered is what is commonly pointed out as the *'blurring of distinctions'* between various financial firms and sectors. This phenomenon concerns a complex of more or less concurring developments, such as the selling of insurance policies by banks, the innovation of unbundling and rebundling of financial products and the emergence of conglomerates. From the viewpoint of supervision and financial stability, financial conglomerates are the most important. To the extent that these institutions are better able to diversify both earnings and risks, they contribute to the stability of the financial system. On the other hand, these conglomerates may be very big in size, and consequently, may increase the systemic ramifications when they run into trouble. Incidentally, this trend has proceeded to different degrees in European countries. Particularly in the Netherlands and the UK, conglomerates play a very important role in the financial sector.

Summarising, the common element of the financial trends discussed is that the linkages between financial markets and institutions, both across border and across sectors, are intensifying. The resulting integration of financial markets makes the financial system more resilient to local asymmetric disturbances, but may at the same time facilitate the transmission of contagion risk.

IV Preventive arrangements: financial regulation

IV.1 Influence of internationalisation

In many respects, financial regulation has been adapted to the trends that are described in section II of this report. In reaction to the internationalisation of the financial sector, several international standard-setting bodies have been established, notably the Basel Committee on Banking Supervision (1974), the International Organisation of Securities Commissions (IOSCO; 1983) and the International Association of Insurance Supervisors (IAIS; 1994). In order to promote the level playing field between financial institutions of different nationalities and to avoid undesirable regulatory arbitrage as much as possible, these international bodies have realised a significant harmonisation of financial regulation. Nonetheless, there remains work to be done, by the above-mentioned fora, as well as by organisations as the Financial Stability Forum and the International Monetary Fund.

Although the harmonisation of financial regulation within the EU is generally consistent with the international standards as agreed by the above-mentioned international fora, it is

often farther-reaching. European financial harmonisation is directed at achieving a single market for financial services, in which banks, insurance undertakings and investment firms authorised by one Member State are allowed to establish a branch or to provide cross-border services into other Member States on the basis of supervision of those activities by the 'home country' supervisory authority. The single market policy is based on the mutual recognition of national regulations of Member States, and therefore requires a considerable degree of financial harmonisation. The advent of new (and probably less advanced) Member States into the system could in this respect pose some important challenges. The harmonised financial regulations encompass high standards of entrance to the market as well as detailed ongoing prudential supervisory requirements, which are all embodied in directives. The legally binding character of directives is another distinguishing feature of the harmonisation of financial regulation within the EU. Progress towards adapting conduct of business and consumer regulation to meet the needs of the Single Market is under way.

The European Commission is assisted in preparing directives in the field of banking, insurance and securities supervision by respectively the Banking Advisory Committee (BAC), the Insurance Committee (IC) and the High Level Securities Supervisors Committee (HLSSC), in which the ministries of finance and the respective national supervisory authorities and, in the case of the BAC, also the central banks are represented. The Financial Services Policy Group (FSPG) helps the Commission to determine its priorities on a cross-sector basis, and thereby indirectly influences the work of the BAC, the IC and the HLSSC. The FSPG was established as part of the Commission's Financial Services Action Plan, which was introduced to improve the Single Market and was endorsed by the Cologne Council on 2 and 3 June 1999. In the process of preparing directives, the EU Ministers of Finance, represented in the Ecofin, negotiate and agree the directives in the field of banking and securities. The EU Ministers of Finance are individually responsible – and thus accountable vis-à-vis their national parliaments – for keeping European directives and national regulations in line with each other.

The regulatory framework in Europe leaves some discretion to national authorities for interpretation and translation into national legislation. This could potentially result in regulatory arbitrage and an unlevel playing field. Different reporting requirements may for example be regarded as a source of inefficiency for reporting institutions. However, this does not necessarily mean that the stability of the European financial system is negatively

affected by remaining differences in national financial regulation. On the contrary, these differences can be judged positive from a viewpoint of financial stability, since national authorities are best suited to take into account the specific characteristics of local markets and individual financial institutions. Although the EU framework of prudential regulation does not need a radical overhaul, there is a need for a more streamlined, flexible and faster legislative approach to respond to the fast moving environment of financial integration and to the new risks that may arise as a consequence.

IV.2 Influence of other trends

Financial regulation has also been adjusted to other relevant trends. For example, *technological innovation* has motivated a number of new or adapted financial standards, although a considerable time lag between the innovation and the adjustment of financial regulation is often unavoidable. The proposals for new capital requirements for banks by the Basel Committee and the European Commission are largely motivated to better address the financial innovation that has occurred in recent years, as shown, for example, by asset securitisation structures. The proposed new capital standards are also aimed at recognising the improvements in risk measurement and control that have occurred. In this way, future capital requirements should better reflect the true risk profile of banks.

Another important trend discussed in section II is the *emergence of financial conglomerates*. In this respect, the work of the Joint Forum on Financial Conglomerates, which is constituted under the aegis of the Basel Committee, the IOSCO and the IAIS, deserves attention. Besides principles with regard to the exchange of information and co-operation between supervisors, the Joint Forum has developed techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis and the judgement of the fitness and properness of managers of financial conglomerates. In an European context, a mixed technical group set-up under the BAC, the IC and the HLSSC is currently developing prudential rules for financial conglomerates following the recommendations of the Joint Forum. The proposals of this mixed technical group are expected by the end of this year, which deserves approval given the importance of financial conglomerates in some areas of the EU.

Adaptation to *concentration and consolidation* has not been considered. As a general rule, international standards agreed by the Basel Committee, IOSCO and IAIS, as well as the EU-

directives do not make a distinction between large and small financial institutions. After all, making a distinction between large and small financial institutions would conflict with the principle of equality and would thereby hamper the level playing field.

V Preventive arrangements: supervision

V.1 Basic principles of co-operation

In light of the trends discussed in section II, extensive co-operation between different authorities involved in the supervision of regulated institutions can be regarded as a key condition for effective supervision. In this respect, there exists broad international consensus that (1) there should not be any obstacles for co-operation and information sharing between supervisors, both at the domestic and the international level; (2) the confidentiality of shared information should be secured, and; (3) supervisors should take a proactive stance towards co-operation, both as providers and requestors of assistance and information. As will be explained below, these principles have been incorporated in the EU-directives.

Generally, the rather far-reaching provisions on co-operation between supervisors in EU-regulation have been motivated by the introduction of the single market for financial services. Although it is impractical to give an overview of all the detailed provisions on co-operation between EU-supervisors in the relevant directives, the following elements appear to be most important. Firstly, the relevant directives impose *an obligation* for banking, insurance and securities supervisors to co-operate and exchange information with their counterparts in other Member-States in relation to institutions operating in their jurisdictions. Secondly, the relevant directives create *the possibility* to exchange supervisory information with other categories of supervisors in the same as well as in other Member States. Finally, the so-called post-BCCCI directive has enhanced the possibilities for the exchange of information between supervisory and non-supervisory authorities within and between Member States. On the basis of this directive confidential supervisory information it is allowed to be passed to central banks and payment overseers for the purpose of the performance of their tasks. These latter authorities may also provide relevant information to supervisory authorities.

The co-operation between banking supervisors has an additional dimension, because of the principle of supervision on a consolidated basis. Consolidated supervision essentially implies that banking supervisors do not only take into account the risks to which a bank

itself is exposed, but also the risks which other members of the same group incur and which may affect the solvency of a bank. In practical terms, applying this principle to a banking group means the aggregation of financial terms, after netting-out intra-group positions, of a bank's overall financial activities. These aggregated figures are the yardsticks for any prudential requirements, such as solvency requirements and large exposure limits. The application of the principle of consolidated supervision requires that the supervisor of the country where a bank has its main establishment, must have insight in the risks of the bank or banking group as a whole. In view of the internationalisation of the financial sector and the emergence of financial conglomerates, it is important that this responsibility is clearly assigned to one (or more) supervisor(s).

The Basel Committee has confirmed the principle of consolidated supervision most recently in the Core Principles (1997). However, there exists no international agreement on the necessity or adequacy of consolidated supervision in the other key segments of the financial industry, namely securities and insurance. Within the EU, banking supervision on a consolidated basis has been introduced simultaneously with the adoption of the corresponding principle by the Basel Committee. A notable aspect of this so-called Directive on the Supervision on a Consolidated Basis of Credit Institutions is that it introduces not only the obligation for supervisors to exchange information on a cross-border basis, but also the obligation to co-operate on a cross-sector basis, if any of the supervised institutions fall within the scope of the Directive. Despite the above-mentioned lack of international agreement, the principle of consolidated supervision also holds for securities firms within the EU, and which is regulated in the Capital Adequacy Directive. Although consolidated supervision is not required for insurance supervision in the EU, a recent directive requires insurance supervisors in certain circumstances to take into account the solvency of the group as a whole in assessing the solvency of individual insurance undertakings (using the so-called solo-plus supervisory model).

Supervision on a consolidated basis can be regarded as a first, important step in the direction of one (or more) lead supervisor(s), or co-ordinating supervisor(s), for large financial institutions (see also the answers on a questionnaire, which are summarised in annex 1). The Joint Forum published proposals for a co-ordinating supervisor in 1997. It functions purely as a *primus inter pares*. The possible elements of co-ordination, which supervisors can use

to define the role of one (ore more) co-ordinating supervisor(s) in emergency and non-emergency circumstances, can be summarised as follows:

- The co-ordinator receives all relevant information from the supervisors involved and provides key information to them in non-emergency situations.
- Idem in emergency situations.
- The co-ordinator makes group-wide assessments of key areas and communicates potential problems to relevant supervisors.
- Overlap in supervisory activities is avoided through bilateral discussions between the co-ordinator and other supervisors.

These elements of co-ordination are far from mandatory, because the Joint Forum explicitly acknowledges the fact that the role and responsibilities of the co-ordinator depend heavily on the specific circumstances of financial institutions, such as the legal framework and the risk profile of the institution involved. Nevertheless, the elements of co-ordination can be regarded as very useful, and in many cases, even necessary conditions for adequate communication and collaboration between different supervisors of the same financial institution. So far, the EU-directives do not provide for one (or more) co-ordinating supervisor(s).

V.2 Co-operation in practice

The co-operation between EU-supervisors in practice has several dimensions. An important channel of co-operation is constituted by several consultative bodies, which provide a multilateral forum for the exchange of information and co-operation between supervisors from different Member States. For banking supervision, the Banking Supervision Committee (BSC) of the ECB is mandated, by the Governing Council, to perform the above-mentioned function, besides assisting the ESCB in contributing to the prudential supervision of credit institutions and the stability of the financial system. A distinguishing feature of the BSC is that both central banks and banking supervisors are represented, which allows for an exchange of views between those authorities which are responsible for safeguarding the stability of the financial system. Within another forum, the Groupe de Contact, banking supervisors exchange views on individual institutions and market developments, and assess trends in the banking sector. With regard to insurance supervision, the consultative body is the 'Conference of Insurance Supervisory Authorities of the

Member States of the European Union' ('the Conference'), which also exchanges information on individual cases. Although several consultative bodies exist within the EU with respect to securities supervision (the Securities Contact Committee, the UCITS contact committee, and FESCO, the Forum of European Securities Commissions), none of them is involved in the exchange of confidential information on individual cases. Finally, the chairmen of the supervisory committees of the different disciplines have started to meet and are well placed to carry forward any work on inter-sectoral information exchange which seems necessary.

In practice, banking supervisors within the EEA also cooperate bilaterally on the basis of so-called Memoranda of Understanding (MOUs), which serve to specify the co-operation between supervisors as envisaged in the Second Banking Co-ordination Directive. At the moment, a comprehensive suit of MOUs is in place, and bilateral MOU-meetings are usually held on an annual basis. MOUs typically include practical provisions with regard to the establishment of a branch, supervisory co-operation on an ongoing basis and co-operation in the field of on-site inspections of, or visits to, branches. Whereas MOUs are designed to facilitate supervisory co-operation with respect to branches, the agreement is often extended by analogy and in informal terms to co-operation with regard to subsidiaries. In addition, non-binding framework agreements exist with certain third countries, under which bilateral co-operation agreements can be signed. The Commission has recently concluded such an agreement with the US Federal Reserve and the OCC. MOUs with Switzerland and Canada will follow soon.

In addition to these general MOUs, some MOUs for specific cross-border financial groups have been signed, in particular between the French and the Belgian banking supervisors with respect to the supervision of Dexia and between the four banking and insurance supervisors of Belgium and the Netherlands with respect to the supervision of Fortis. The main motivation for these specific MOUs is to provide clarity on the supervisor(s) responsible for co-ordinated supervision or group-wide supervision. In the specific case of the merger of MeritaNordbanken and Unidanmark, the conglomerate is to be supervised by authorities in four countries, which may give rise to the need for multilateral MOUs.

Many European securities supervisors have also signed bilateral MOUs for the exchange of information with other Member States. The EU-insurance supervisors have, under the aegis

of the above-mentioned ‘Conference’, agreed on a detailed set of rules and procedures with regard to information exchange and co-operation in the form of so-called protocols. These protocols constitute a multilateral memorandum of understanding between insurance supervisors on how proceed in a common manner towards the effective supervision of insurance undertakings that operate under the EU-directives. In this way, the protocols obviate the need to enter into bilateral MOUs for insurance supervisors. There may be a need to ensure that the memoranda and protocols are sufficiently uniform in content and that they are reviewed regularly.

VI Crisis management

VI.1 General description

Despite the preventive arrangements discussed in the last section, financial difficulties at individual firms, resulting for example from external disturbances, can not be ruled out. In such a situation both the supervisory authorities and other authorities, in particular the central bank, can deploy different instruments to avoid potentially disruptive effects on the financial system as a whole. In the early stages of financial problems at individual institutions, supervisors can take a variety of measures ranging from a re-assessment of the financial situation of the institution involved to the appointment of special auditors. However, if these supervisory actions do not have the desired effect in time, and the difficulties at one institution potentially threaten the confidence in the financial system as a whole, different crisis management instruments can be deployed.

An important crisis management instrument is orchestrating or at least encouraging a purely private sector solution, such as organising take-overs or facilitating liquidity support by the private sector by providing information. The supervisory authority will provide information about the troubled institution and about possible candidates to support this institution, whereas the central bank may have to provide a transitional financing arrangement. In these circumstances, there are advantages when central banks are formally responsible or otherwise closely involved in banking supervision, since this shortens the lines of communication as much as possible. Furthermore, central banks may provide liquidity to the market as a whole. Also, central banks may provide liquidity support to individual institutions, whereas the government might intervene when the solvency of the troubled financial institution is lacking.

It is well known that the availability of financial support for individual institutions, just like any insurance, creates moral hazard, in the sense that it may induce financial institutions to take additional risks. In principle, where liquidity support can be clearly separated from the provision of risk capital, the moral hazard created will be limited to possible mismanagement of liquidity risk. Capital support however, may raise expectations that the financial institution is insured against the mismanagement of virtually all types of risk. It should be noted, however, that the scope for providing risk capital support by governments is very limited in a European context, since the European Commission is directly involved in scrutinising whether the state aid is compatible with Community's competition legislation.

VI.2 Influence of major financial trends

The use of crisis management tools has been influenced by the *introduction of the euro*. The euro-countries have agreed on mechanisms for providing liquidity assistance to individual institutions. An important principle of this agreement is that the responsibility for granting liquidity support to individual institutions remains primarily at the national level, with the national central banks concerned. Accordingly, all the costs and the risks relating to the support operations are to be borne at the national level. Mechanisms have been devised in order to ensure that: (1) any potential liquidity impact can be managed in a way that is consistent with the maintenance of the appropriate monetary policy stance in the euro area; and (2) cross-border implications can be dealt with by the competent authorities. This means that an adequate flow of information has to be conveyed to the decision-making bodies of the ESCB in due time, especially when the amount of central bank liquidity is large enough to have a bearing on the implementation of monetary policy.

In view of the *internationalisation* of the financial sector, the question arises on how supervisory authorities handle a situation in which an internationally operating financial institution runs into difficulties. Depending on the crisis management instrument that is considered to be most effective under the specific circumstances, it may be expected that either the central bank, the supervisory authority, the Deposit Insurance Fund or, in extreme cases the ministry of finance of the home country of the parent of the group, will take the lead management in rescue operations. Obviously, this does not mean that the home country will automatically bear all the risks or the costs of rescue operations. If a supervisory action, such the requirement to restrict business or a private sector solution, is judged to be

sufficient to avoid widespread financial instability, then the home supervisor of the legal entity that is the parent of the group will be the natural lead manager of these actions. When the use of one of the other crisis management instruments mentioned is needed, the central bank of the home country of the troubled institution may normally perform the task of coordinating the policies of the different authorities involved.

Incidentally, the use of crisis management instruments has traditionally been confined to banks, because they are the most relevant from the viewpoint of financial stability. As a result of the phenomenon of *financial conglomeration* between different types of financial institutions, the question arises whether the limitation of the application of crisis management tools to banks is still justified. Where the range of banks' activities extends beyond banking, it is difficult or impossible in practice to confine crisis management tools to banking activities alone. In addition, as other types of financial intermediaries are involved in banking activities, or in activities that are comparable to banking, their failure might potentially have systemic consequences as well. Even more important is the case of contagion from within a big financial conglomerate. As a general rule, central banks will not provide liquidity assistance to non-bank financial institutions, but try to orchestrate private sector support if that might help to avoid systemic disruption. The policy of the US Federal Reserve in response to the LTCM-crisis is a case in point here.

Finally, several instruments are used when a troubled financial institution is not rescued, and thus goes bankrupt, namely deposit guarantee systems and winding-up procedures. Within Europe, the Deposit Guarantee Directive has introduced the principle of home country control for national deposit protection schemes, which implies that funds deposited at foreign branches of banks are covered by the deposit guarantee system of the home country of the firm concerned. The Deposit Guarantee System sets minimum standards for deposit protection. It is notable that winding-up procedures have not been harmonised within the EU, although there has been a proposal on the table for a directive on this matter since 1988. Consequently, there exists no clarity on the division of responsibilities between home and host supervisors in the case of the winding-up of an internationally operating financial institution. Practical arrangements to break the political deadlock on these proposals are underway. Every effort should be made towards rapid adoption by the Council and the European Parliament of the proposals which are a vital component of legal clarity and financial stability in this area.

Annex: Members of the ad hoc Group on financial stability

Henk Brouwer*	Chairman, De Nederlandsche Bank
Lorenzo Bini Smaghi*	Ministero del Tesoro
Hervé Carré *	European Commission
Robin Fellgett	HM Treasury
Hervé Hannoun *	Banque de France
Joachim Henke	Bundesministerium der Finanzen
Miguel Martin *	Banco de España
Edgar Meister	Bundesbank, and Chairman BSC
Claes Norgren	Finansinspektionen (Sweden), and Chairman BAC
Esko Ollila *	Suomen Pankki
Tommaso Padoa Schioppa	European Central Bank
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