TRENDS IN INSTITUTIONAL STRUCTURE OF FINANCIAL REGULATION AND SUPERVISION IN THE EUROPEAN UNION[1]

Emília Zimková – Viktória Vargová

The aim of this article is to give a brief description of financial regulation and supervision in terms of its institutional structure models and its integration, and to provide a consistent overview of how the institutions that regulate and supervise the financial market in the European Union are structured. In the section on the supranational organization of financial regulation and supervision, we outline the trends for further development in this area.

Institutional structure models for financial regulation and financial market supervision

As regards the institutional structure of financial regulation and supervision in individual countries, two models may be distinguished: sectoral (branch) models and functional models.

The sectoral, or branch, model is based on the fact that authorities supervise and regulate institutions according to core sectors of financial mediation (banking, capital market and investment services, insurance and supplementary pension insurance). The sectoral model has three variants:

• Separate regulatory and supervisory institutions for banking, capital market and investment services, and supplementary pension insurance;

• Partial integration of supervision, for example, the linking of banking supervision with regulation and supervision of the insurance market, or the "two-pillar system"; the central bank regulates and supervises banks, and another independent institution regulates and supervises non-banking financial institutions and the capital market;

• Full integration of supervision with a single institution supervising all the core financial service industries and the capital market.

The functionality model depends on the typology of market failure. In the area of financial mediation there are four main types of market failure: asymmetry of information, misuse of markets, systemic risk, and misuse of a dominant market position. The types of market failure are mirrored by the specializations of financial regulation and supervision:

• Regulation of financial institutions for prudential business and the supervision of them (prudential regulation and supervision), which focuses on the financial soundness, liquidity and solvency of financial institutions;

• Supervision directed at misuse of the organized capital market and of over-the-counter trading. The aim is to protect the customers of financial institutions (consumer protection);

• Monitoring and analysing the stability of the banking sector as a whole, which lessens the probability that a systemic risk will materialize in the cross-default of banks and other financial institutions (systemic regulation and supervision);

• Regulation and supervision of the competitive environment, which curbs the scope for misuse of a dominant market position. In every country, the remit of the anti-monopoly office covers the whole economy. To create a special anti-monopoly office for financial markets would not be effective.

Like the sectoral model, the functional model has three variants:

• Separate regulatory and supervisory institutions for investor and consumer protection focused on fair use of markets. One institution is responsible for prudential regulation and supervision, while the central bank has the role of creditor of last resort and oversees the stability of the whole financial system, and there is eventually a regulator of economic competition;

• Partial integration of supervision, where, for example, the supervision of banking and non-banking institutions for prudential business is performed by the central bank and is thereby related to the supervision of financial stability and with the function of creditor of last resort. Besides the central bank, there is a regulator for fair use of the market and another regulator to supervise economic competition;

• Full integration of supervision means that one regulatory institution is entrusted with supervision of all types of financial regulation and supervision. In practice, this is identical to the full integration of supervision in terms of sectors (branches).

Factors supporting the integration of financial regulation and supervision

The factors supporting integration of financial regulation and supervision undoubtedly include the current deve-

[1]This article is published as part of the project VEGA1/2594/05 "Analysis of selected issues of the financial and banking market following the accession of Slovakia to the European Union".

lopment in financial markets. The interconnection of different financial industries – reflected in the growing strength of financial groups and in the expansion of trading in hybrid financial instruments and risk transfer instruments – is putting pressure on the coordination of financial regulation and supervision. Among other factors supporting the integration of financial regulation and supervision is the growth in cross-border financial flows.

Integration of financial regulation and supervision is also boosted by the need to apply consistent policy in relation to the different industries of financial mediation. This is important because banking and non-banking financial institutions operate in the same market and their products are often either mutually competing or complimentary.

Synergic effects represent another factor supporting the integration of financial regulation and supervision. As financial products become more complex, regulatory institutions are having to employ specialists who understand them. If the supervision is integrated, these specialists may be employed in different branches of financial regulation and supervision.

Table 1 Institutional structure of financial regulation and supervision in EU Member States

Country	Banks	Insurance companies	Capital markets and investment services	Characteristic
Belgium				Full integration outside CB
Cyprus				Sectoral model
Czech Republic				Full integration under CB
Denmark				Full integration outside CB
Estonia				Full integration outside CB
Finland				Two-pillar model – the first pillar includes integration of banking, capital market, and investment services supervision (RIa), the second pillar includes the supervision of insurance services (RIb)
France				Sectoral model, banking supervision outside CB
Greece				Sectoral model
The Netherlands				Functional model since 2005
Ireland				Full integration under CB
Lithuania				Sectoral model
Latvia				Full integration outside CB
Luxemburg				Full integration outside CB
Hungary				Full integration outside CB
Malta				Full integration outside CB
Germany				Full integration outside CB
Poland				Sectoral model, banking supervision as an autonomous part of CB
Portugal				Sectoral model
Austria				Full integration outside CB
Slovakia				Full integration under CB
Slovenia				Sectoral model
Spain				Sectoral model
Sweden				Full integration outside CB
Italy				Sectoral model at present, functional model being prepared
United Kingdom				Full integration outside CB

Source: Czech National Bank 2005 – Institutional structure of financial regulation and supervision in the EU and the role in financial regulation and supervision for banks of the European System of Central Banks amended by authors. Available at www.cnb.cz Key: CB – central bank, RI – regulatory institution other than a central bank

Economies of scale arise from the fact that the integrated institution uses only one system of ancillary services (human resources management, information system, accounting and financial management of the institution, buildings administration, library, research). Another source of economies of scale is the introduction of the same procedures for licensing, imposing fines, and so on.

A further argument for integrated financial regulation and supervision is the removal of possible duplication or negative disputes over competences between different institutions.

Sometimes market size is presented as a factor supporting the integration of financial regulation. In Slovakia, the financial market is really limited, but even in the United Kingdom and Germany, two of the largest national markets in the world, the integrated financial market is also working.

For integrated financial regulation and supervision to be effective, it is necessary to have clearly defined objectives of financial regulation and supervision, an independent regulatory institution, sufficient funding, educated, experienced and professionally competent employees, an appropriate legal framework, and implementation of international standards for financial regulation and supervision.

Institutional structure of financial regulation and supervision in the European Union

Although national regulations vary across the EU, there is a discernable trend of integrating regulatory and

[2] Mutually competing products include, for example, bank time deposits and unit certificates of guaranteed funds; complementary products include, for example, mortgages and life insurance.

Table 2 Forms of central bank participation in the performance of banking supervision

Country	CB performs banking supervision	Partial CB participation in banking supervision		
		Participation in top authorities	CB participates in performance of supervision	CB contributes funds to the performance banking supervision
Belgium	No	Yes	No	No
Cyprus	Yes			
Czech Republic	Yes			
Denmark	No	No	No	No
Estonia	No	Yes	No	Yes
Finland	No	Yes	No	Yes
France	No	Yes	No	Yes
Greece	Yes			
The Netherlands	Yes			
Ireland	Yes			
Lithuania	Yes			
Latvia	No	Yes	No	Yes
Luxemburg	No	No	No	No
Hungary	No	No	No	Yes
Malta	No	No	No	No
Germany	No	No	Yes	Yes
Poland	Yes			
Portugal	Yes			
Austria	No	Yes	No	Yes
Slovakia	Yes			
Slovenia	Yes			
Spain	Yes			
Sweden	No	Yes	No	No
Italy	Yes			
United Kingdom	No	Yes	No	No

Source: European Central Bank. 2003. Developments in National Supervisory Structures. ISBN 92-9181-368-0.

supervisory authorities into a single institution. The main argument for doing so is to simplify the licensing (authorization) process for institutions that want to provide financial services in several financial market sectors, and to reduce supervision expenses.

As has been shown by J. Makúch (2002), the integration of regulatory and supervisory authorities is in line with the evolutionary trend in the financial market – the formation of multisectoral financial conglomerates. It provides scope for comprehensive expertise and an ancillary service, and unifies rules for individual sectors of the financial market. Other positives include increased transparency for market participants and the elimination of the time delays that occur when several institutions have to be coordinated to deal with multisectoral issues.

The process of establishing "integrated authorities" began in the second half of the 1980s. The first such institutions emerged in Scandinavia (Norway – 1986, Denmark – 1988, Sweden – 1991), Canada (1987), Japan, Australia, and, from among EU countries, the United Kingdom (1998), Ireland, and, in recent years, Germany, Austria, the Netherlands, and Iceland. Among Visegrad Four countries, the integrated model exists in Hungary (1997), Slovakia (January 2006), and Czech Republic (April 2006).

As Table 1 shows, a slightly predominant number of countries have an integrated institutional structure (15:10) and also in the other countries there is a prevailing trend towards integration.

In some EU countries, the central bank does not perform banking supervision but plays a significant role either through participation in the top supervisory authorities, or by contributing to the performance of supervision, or by contributing to the provision of the human, technical and financial resources necessary for supervision.

As the table makes clear, 90% of EU countries have a central bank with a key role in, or significant influence over, banking supervision. It is also not unusual to have integrated supervision concentrated in the central bank (the Netherlands, Ireland, Slovakia, Italy, Czech Republic).

Institutional structure of financial regulation and supervision at the supranational level

Representatives of national regulatory and supervisory institutions are now discussing the creation of a "supranational supervisory institution". This would oversee precisely defined areas without regard to which financial intermediaries provide them. It would to some extent address the issue of regulatory asymmetry where banks are subject to tougher regulatory rules than are non-banking financial institutions. This would at the same time be a response to the globalization of financial markets, which requires the creation and control of "global rules". Although the prevailing opinion is that the establishment of such an institution is currently unrealistic and that mutual cooperation is far more effective (Revenda 2001), we take the view that the creation of a supranational integrated institution is supported by the same factors that we mentioned in the second section.

The most important roles in this area are played by the Basel-based Bank for International Settlements and its Basel Committee on Banking Supervision (BCBS), founded by the central bank governors of the Group of Ten Nations and Luxemburg. The BCBS meets on a regular basis at least four times a year, and its most significant output is the rules on capital adequacy (Cook ratio). The main objectives of the BCBS are:

- to support stability in the international banking system,
- to press for removal of competitive inequalities between regulatory rules, especially in regard to capital adequacy requirements,
- to unify conditions under which banking licences are awarded,
- to unify risk coverage principles and methods,
- to set guiding principles for the creation of regulatory rules.

For EU countries, the Banking Supervision Committee (BSC) has a significant role. It focuses on the coordination of banking regulations in EU countries, and its directives are often adopted, or used as templates, by these countries. Besides coordinating banking regulations, the BSC seeks to regulate investments in securities.

The BCBS and BSC cooperate closely with the International Organization of Securities Commissions (IOSCO). The result is the preparation of regulations on capital adequacy in commercial and investment banking. Among the other international bodies are the International Accounting Standards Committee (IASC) and the International Association of Insurance Supervisors (IAIS).

Summary

National regulations within the EU vary and reflect the historical development of financial markets and their regulation. At the national level, there is a discernible trend towards integrating regulatory and supervisory authorities into a single institution. The main argument for doing so is to simplify the licensing process for institutions that want to offer financial services in several financial market sectors, and to reduce supervision expenses. The integration of regulatory and supervisory authorities is in keeping with the evolutionary trend in the financial market – the formation of multisectoral financial conglomerates. It provides scope for comprehensive expertise and an ancillary service, and unifies rules for individual sectors of the financial market. Other positives include increased transparency for market participants and the elimination of the time delays that occur when several institutions have to be coordinated to deal with multisectoral issues. As regards integration of regulatory and supervisory institutions at the supranational level, it is currently the subject of expert discussions. In our view, the creation of a properly competent "supranational institution for regulation and supervision" would clarify, streamline and simplify the whole process of financial regulation and supervision.

Bibliography

1. Assadulah, A.: Minimálna kapitálová požiadavka na krytie kreditného rizika podľa novej Bazilejskej dohody o kapitáli – Bazilej II – 1. časť (Minimum capital requirement for covering credit risk under the New Basel Capital Accord – Basel II, 1st Part); Biatec vol. 13, 2005, No. 10, ISSN 1335-0900.
2. Assadulah, A.: Minimálna kapitálová požiadavka na krytie kreditného rizika podľa novej Bazilejskej dohody o kapitáli – Bazilej II – 2. časť (Minimum capital requirement for covering credit risk under the New Basel Capital Accord – Basel II, 2nd Part); Biatec vol. 13, 2005, No. 11, ISSN 1335-0900
3. Bača, J.: Bankový dohľad (Banking supervision); Ekonóm, 2001.
4. Dvořák, P.: Komerční bankovnictví pro bankéře a klienty (Commercial banking for bankers and clients); Prague, 2005, ISBN 80-7201-310-6.
5. European Central Bank: Developments in National Supervisory Structures; June 2003, ISBN 92-9181-368-0.
6. Gonda, V.: Bankový dohľad v optike Basel II (Banking supervision as seen through Basel II); Ekonomický časopis, 52, 2004, No. 6, ISSN 0013-3035.
7. Horvátová, E. 2000: Bankovníctvo (Banking); Bratislava, Súvaha, 2000, ISBN 80-88727-42-1.
8. Makúch, J.: Finančný trh, jeho regulácia a dohľad – vývoj a trendy v EÚ (The financial market, its regulation and supervision – development and trends in the EU); Anthology of the conference "European finance, theory, policy and practice", Matej Bel University in Banská Bystrica, 2004, ISBN 80-8055-639-3.
9. Revenda, Z.: Bankovní regulace a dohled (Banking regulation and supervision); Prage, Nad Zlato, 1993.
10. Revenda, Z.: Centrální bankovníctví (Central Banking); Prague, Management Press, 2nd expanded edition, 2001, ISBN 80-7261-051-1.
11. Zimková, E. et al: Európska únia – vybrané problémy (European Union – selected issues); Banská Bystrica, Faculty of Finance, 1st edition, 2005, ISBN 80-8083-066-5.