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BANKING SUPERVISION IN EUROPEAN UNION

Literature review

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Abstract

The need for prudential supervision imposed to banks by law arises from the action that banking market's basic factors have. Therefore, it is about banks' role in economy. The normal functioning of banks in all their important duties maintains the stability of banking system. Further, the stability of the entire economy depends on the stability of the banking system.

Under conditions of imbalance regarding treasury or liquidity, banks are faced with unmanageable crisis and the consequences can be fatal. To ensure long-term stability of the banking system, supervisory regulations were constituted in order to prevent banks focusing on achieving rapidly high profits and protect the interests of depositors. Starting from this point, this paper will carry out a study on existing models of supervision in the European Union's Member States. A comparison between them will support identifying the advantages and disadvantages of each of them.

1. INTRODUCTION

Financial institutions have a beneficial role in the economy since they act as intermediaries. They ensure funds channelling them from savers to persons with investment opportunities. In the literature it is generally accepted the importance of the banking sector in the economy. It is also known that the development degree of banking sector influences firm's economic and financial performance.

Giving the banking system's role in the economic development of a country, the need for regulation appears. Further, banking supervision becomes an imperative task. Monitoring banks' financial situation and checking how bank regulations are met and enforced becomes a priority on public authorities' agenda. The entire economy depends on the stability of the banking system, as an essential link in the saving-investment process.

Decades passed until market discipline in the banking sector has been taken into account, but, today, banks have become the most regulated segment of the financial industry mainly because of the potential "domino" effect to which they are subject. These risks may cause losses to the entire economy.

Regulations in the field are given by the Basel II international framework and European directives for European Union Member States. For the future, a Basel III is considered to be implemented until 2018. At a national level Central Bank is also the institution that has regulatory powers.

In the literature, there are a lot of studies on regulation. Rochet, J. C. (2004) [1] builds a model to show the need of prudential regulation and proposes some directions of regulatory system's reform. Kahn, C. M. and Santos, J. A. C. (2005) [2] are discussing the problem of one regulatory power, Angkinand, A. P. (2009) [3] analyzes the relationship between banking regulation and supervision. Mosley, L. and Singer, D.A. (2009) [4] are debating the issue of regulation in the light of recent financial crisis. Tchana Tchana, F. (2012) [5] shows in his work how capital adequacy requirements promoted by Basel Accord influence economic growth by determining banks to have less risky portfolios, but unproductive.

Banking supervision is the activity carried out by the supervisory authority over all banking entities and consists of pursuing how they accomplish regulations on prudential requirements. Prudential requirements ensure both the application of prudent policies and banking practices for bank's own interest and for its customers, as well as the credibility and viability of the entire system. This means banking supervision provides health to the banking system. Studies on supervision are numerous, too. Padoa-Schioppa, T. (1999) [6] is discussing the problem of banking supervision and monetary policy in the euro area where the latter is a responsibility of the European Central Bank. Quaglia, L. (2008) [7] is examining the recent reforms in the United Kingdom, Germany, and Italy, engaging in a structured comparison. Davis, P. and Obasi, U. (2009) [8] demonstrate the key role of supervision by exploring the relationship between financial soundness indicators and approaches to banking supervision adopted around the world. Maddaloni, A. and Peydró, J. L. (2011) [9] are also discussing supervision using evidence from the euro area. Barth, J. R., Caprio, G., and Jr. Levine, R. (2013) [10] are elaborating a comparative approach regarding regulation and supervision in 180 countries and the evolution in time of these aspects.

The most important functions of banking regulation and supervision consist of investors' protection, micro-level supervision that focuses largely on protecting depositors and macro-prudential analysis which includes monitoring the exposure to systemic risk and identifying potential macroeconomic threats caused by financial markets' development.

Financial stability reflects the situation when financial system works effectively, being able to allocate resources efficiently, to dissipate risks and to ensure debts settlement, even if it is about shocks, crisis or major structural changes. Schinasi, G. J. (2006) [11] says that this is the ability of the financial system to facilitate and enhance economic processes, manage risks, and absorb shocks. Wood, G. and Allen, W. A. (2006) [12] consider that the best way to define financial stability is a state of affairs in which episodes of instability are unlikely to occur. As demonstrated by the recent economic crisis, financial stability plays a key role in the financial system and the economy as a whole. Given the increasing number of financial institutions that are currently active in one or more countries or on one or more continents, global financial stability has become even more important.

Globalization favours the occurrence of systemic risk. It occurs when an individual problem (at a single bank) may spread into the entire banking system. A generalized problem at this level can have strong adverse consequences on the real economy.

Financial stability is a widely studied topic in the literature. Crockett, A. (1996) [13] is explaining the sources that are causing financial instability. Quintyn, M. and Taylor, M. W, (2002) [14] believe that bank regulators and supervisors require a significant degree of independence in order to ensure financial stability. Nier, E., Yang, J, Yorulmazer, T. and Alentorn, A (2007) [15] are bringing to light the relationship between financial stability and systemic risk and are studying the way some parameters (like the level of capitalization, the degree to which banks are connected, the size of interbank exposures and the degree of concentration of the system) influence the stability of the banking system. Tobias, A. and Hyun Song, S. (2008) [16] are demonstrating the close relationship existing between financial stability and monetary policy. Schoenmaker, D. and Wagner, W. (2011) [17] are analyzing financial stability in terms of contagion determined by cross-border banking.

In international practice, generally, there are found two supervision models: institutional supervision and integrated supervision (unified). The first model follows the classical segmentation of financial sector in three markets, so that the prudential control work is focused on a specific category of financial institutions. The second involves a single agency, usually different from the Central Bank, which supervises the financial market as a whole. This body is named Financial Stability Authority (FSA). Regardless of the chosen model of supervision, the most important instruments through which the prudential supervision is made are: bank rating systems, stress tests and contamination tests, early warning systems, loans reporting systems and deposit guarantee schemes.

Experts in this domain have different views about supervision models.

There are some main arguments in favour of maintaining the function of banking supervision within the Central Bank. One of them is the high degree of independence enjoyed by the Central Bank in most developed countries, and especially within the European Union. This allows it to make the difficult decisions required by the banking supervision's functions without being subject to political pressures, as might happen with another institution. The Central Bank's credibility is another argument. The credibility, generally superior to that of other national institutions, plays a decisive role in preventing or alleviating banking crisis since an early stage (in many cases, statements made by Central Banks' officials or certain actions taken by Central Banks have stopped the public panic).

Also, due to the overall vision of the economy as a whole, the Central Bank is the institution that holds most of the information needed to identify the main risk factors for the banking system in time. In all developed economies Central Bank supervises the payment systems which have a systemically importance. Some experts consider that the separation of banking supervision by payment systems supervision is risky.

Equally, there are arguments in favour of FSA models, respectively against performing prudential supervision by the Central Bank. Some of them will be mentioned in the following. There is a perception of an interest conflict between the fundamental purpose of any Central Bank - price stability - and its supervisory role in quality of lender of last resort. It is believed that, in the event of a crisis, the Central Bank might be too generous when granting financial support to ailing banks in order to avoid a loss of credibility, which would increase inflationary pressures and would determine the failure of monetary policy objectives. Multiple surveillance agencies would increase the cost of supervision with an impact on the competitiveness of supervised entities. Separating the supervision in specialized agencies makes it more difficult to disseminate lessons learned from a financial crisis happened within a subsystem, thus limiting the possibilities for future reaction of other supervisors. A growing interdependence between sectors makes that a narrow focus on a particular sector to be sometimes ineffective in preventing systemic risk. The obvious increasing blurring regarding boundaries between financial institutions' activities and globalization that has led to the emergence of financial conglomerates is also an argument in favour of a FSA.

A multitude of studies examine the separation of monetary policy from banking supervision. Therefore, this implies that monetary policy remains the Central Bank's responsibility and banking supervision being taken by another agency. Goodhart, C. A. E. and Schoenmaker, D. (1995) [18] are addressing the separation issue and conclude that one model is not better than the other one. They rather believe that choosing the best version depends on the particular structure of banking systems. A general model cannot be defined as each country has a unique banking structure. Haubrich, J. G. (1996) [19] starting from the case of Federal Reserve, that is responsible for both monetary policy and bank supervision, raises the question which model is the best. His conclusion is that it depends on a country's prevailing conditions (financial system, political environment, and the preferences of the public) again. Di Noia, C. and Di Giorgio, G. (1999) [20] are showing the arguments in favour and against this issue, but they also treat this issue by their own and find that the inflation rate is higher in countries where banking supervision is carried out by Central Bank. Goodhart, C. A. E. (2002) [21] examines how much it matters if banking supervision belongs to a separate institution different from Central Bank. He concludes that, whatever the decision of a country in this regard is, there must be a close cooperation between the Central Bank and various supervisory institutions. He also recommends that, in emerging countries banking supervision should be maintained in the Central Bank because of staff quality and its independence. Barth, J. R., Nolle, D. E., Phumiwasana, T. and Yago, G. (2003) [22] analyze the relationship between supervisory framework and banks' performance using data from 55 countries. Franck, R. and Krausz, M. (2008) [23] are studying this problem in relationship with political preferences on inflation. Cihak, M. and Podpiera, R. (2008) [24], using data from 84 countries, conclude that supervisory integration is associated with higher quality supervision and greater consistency of supervision across financial sectors. Boyer, P. C. and Ponce, J. (2012) [25]

believe that the supervision of different dimensions of the riskiness of banks should be conducted by different supervisors.

2. BANKING SUPERVISION IN EUROPEAN UNION

Until late 1990s banking supervision was exercised normally in most countries by Central Banks. Other financial sectors - mainly capital market and insurance market - were controlled by separate entities. So, here it is about institutional supervision. If financial markets were complex, the number of these entities could be very high. For example, in the United Kingdom in 1996 were operating a number of 9 financial market supervisors. After this year, when BCCI (Bank of Credit and Commerce International) and Barings Bank collapsed, banking supervision was removed from the Bank of England’s list of attributions and transferred to a separate body. The debates on this issue led to the establishment, in 1998, of Financial Stability Authority (FSA), a supervisory body that since 2001 has integrated functions of all other financial sector supervisors. Bank of England remained responsible for ensuring the overall stability of the financial system. Thus, United Kingdom has passed to unified supervision. After this event, Europe has won many adepts of integrated supervision. Many countries adopted the unified model. Among them it can be mentioned Luxembourg, Netherlands, Portugal, Germany, Ireland, Finland, Austria, Hungary, Estonia, and Belgium.

In 2002 a new model of financial regulation and supervision has been introduced in Netherlands. This was called “twin peaks” and was characterized by two major institutions - the Central Bank as the sole supervisor of all financial institutions and Authority for Financial Markets (AFM) responsible for the supervision of business conduct. The transition to this model was completed in 2007. Subsequently, the model has been adopted in many other countries, reflecting the increasing dominance of complex financial institutions and their activities’ interconnectivity. This leads to the need of increasing macro-prudential supervision with a focus on systemic risks. Preference for this type of supervision was determined by changes that took place in the banking industry. Following the global trend, the Dutch financial system has become dominated by a few sizeable conglomerates. So, the decision to bring together the supervision of banks, pension funds, investment funds and insurance companies responded to the challenges posed by large financial conglomerates.

"Twin peaks" is a model based on objectives since the Dutch Central Bank has become the single supervisory institution for all financial institutions (banks, insurance companies, investment funds, pension funds, and securities firms) and AFM a supervisor responsible with business conduct, especially regarding market behaviour and consumer and investor protection. Integrating prudential supervision under Central Bank’s wings determines supervision to build on its long-term credibility as financial institutions get more and more new areas with risky challenges.

Further, the Dutch model has been adopted by other countries, too - both in the European Union and beyond. Some of them have applied the model before the recent global financial crisis and some of them after this event, as can be seen in the table below, along with other information on the type of unified supervision.

As can be seen, several countries have adopted the “twin peak” model after the financial crisis. The proper functioning of this model during the financial crisis was possible due to a well-established law that specifies roles, responsibilities and limits of each institution involved.

But not all EU countries are interested in the new model. The supervisory structure with a single institution, which, contrary to the Dutch model is now called "one peak", is still approached by Finland, Germany, Denmark, Sweden, Hungary, and Poland.

Although, according to the British model, most states had adopted before the financial crisis a FSA version with an agency independent from Central Bank; after this global event a serious number of states are planning to integrate the supervision function within the Central Bank (Italy, Spain, France, and Great Britain).

So, as already mentioned, both "one peak" and "twin peaks" model are variants of unified supervision. The latter, however, has the advantage of decoupling objects so that the prudential supervision is separated from business conduct supervision. Each of the two objectives is met by another institution. The advocates argue that, despite the close relationship between the two objectives, different skills and tools are required in order to be achieved. Prudential supervision ensures financial stability, while the business conduct has to protect consumers and investors. Another major advantage is the integration of supervision back to the Central Bank, which does not happen for "one peak" model. Since monetary policy is no longer a function of the Central Banks of the EMU member states, supervision can be exercised easily. There is no longer a conflict of interest between the various policies of the Central Bank. In addition, as mentioned, returning supervisory function within the Central Bank benefits from a surplus of confidence and independence.

Further, this paper shows the countries' differences regarding regulation and supervision.

3. A COMPARATIVE APPROACH IN EUROPEAN UNION MEMBER STATES

As the latest statistics from year 2007 of World Bank show [27], in 15 of 27 countries, Central Bank is the one who is carrying out prudential supervision. The remaining states have a single supervisory agency. Most times this single agency oversees the entire financial system as a whole. In Belgium it is called Banking, Finance and Insurance Commission (CBFA), in Estonia this is Estonian Financial Supervision Authority, BaFin in Germany, the Financial and Capital Market Commission in Latvia, Malta Financial Services Authority in Malta and so on.

Most states have a single financial supervisory agency for all activities allowed to commercial banks, but there are exceptions such as Bulgaria, Denmark, Italy, Lithuania, Netherlands, Romania, Spain, and Slovenia. Usually this institution is either the Central Bank or the FSA or equivalent.

With respect to the authorities to whom the supervisory bodies are responsible, there is great diversity in the European Union. Thus, in Italy and Malta supervisory agency is responsible to the Prime Minister, in Austria, Belgium, Denmark, Germany, Hungary, Ireland, Italy, Luxembourg, the Netherlands and Sweden it is accountable to the Minister of Finance. Furthermore, Austria, Bulgaria, Cyprus, Czech Republic, Finland, Hungary, Italy, Latvia, Italy, Portugal, Romania, Slovenia and the United Kingdom are accountable to the Parliament (or Congress, as applicable). It can be noted that some countries (as Austria, Hungary, Italy) supervisory agencies respond both to Parliament and to the Minister of Finance.

The appointment of Central Bank's governor or president is the decision of the Head of Government (Prime Minister) in Austria, Cyprus, Czech Republic, Finland, Germany, Greece, Hungary, Malta, the

Netherlands, Spain. It is the decision of the Minister of Finance in Belgium, Denmark, France, Ireland, and Great Britain. Finally, it is the Parliament's decision in Bulgaria, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Governors, Chairman of the Supervisory Agency and other directors have a limited function in most states. Exceptions are Finland, Germany and Slovakia. Where their mandate is fixed, it lasts between 3 and 8 years.

Dismissal of the Central Bank's governor or supervisory institution's president is made by the President or Prime Minister in the Czech Republic, Finland, Germany, Malta and the Netherlands, by the Minister of Finance in Austria, Denmark, Ireland and the UK, by Parliament in Bulgaria, Hungary, Latvia, Lithuania, Poland, Romania and Slovenia. In countries such as Estonia, Greece, Italy, Portugal, Slovakia, Sweden this task lies with another authority.

The number of employees of supervisory institutions directly involved in prudential supervision varies in EU Member States from 25 to 50 in Cyprus, Denmark, Estonia, Ireland, Latvia, Lithuania, Luxembourg, Malta, and Belgium. There are up to 100-150 in Bulgaria, Greece, France, the Netherlands, Slovakia, Sweden, and Finland and even over 300 in Spain, Poland, and Italy. Here is a wide range depending on the needs of each country.

In terms of on-site supervision, the average number of visits in a bank in 5 years was one or less in Germany, Poland, Lithuania, Italy, around two in Portugal, Luxembourg, Hungary, Spain, Estonia, Czech Republic, from three to five visits in Belgium, Bulgaria, Cyprus and Romania. More than 5 visits were made in Latvia and Sweden. For medium-size and large banks on-site inspections are in all states once a year or every two years.

If during surveillance a prudential infraction is identified, it must always be reported. This is available for all countries. There are certain measures that supervisors should apply in the case of irregularities and here it is about Bulgaria, Cyprus, Denmark, Finland, Greece, Ireland, Italy, Lithuania, Luxembourg, Malta, Netherlands, Poland, Romania, Slovakia, Slovenia, and Spain. In some countries, such as Bulgaria, Cyprus, Denmark, France, Greece, Luxembourg, Malta, Netherlands, Slovakia, Slovenia, Spain exceptions from punitive measures may be applied. Usually this is the decision of the Governor of the Central Bank.

Finally, the liability of the persons involved in the supervision can be held in case of deterioration of a bank due to an omission in the performance of their duties in the Czech Republic, Greece, Italy, and Lithuania. Instead, the supervisory agency may be liable for deterioration caused to a bank due to supervisory action errors in several states. This is the case of Belgium, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, Poland, Portugal, Romania, Slovakia, Slovenia, and Spain.

4. CONCLUSIONS

Prudential supervision is indispensable for financial stability of any economy. From this perspective, financial systems require regulations to ensure effective supervision of both banking sector and financial system as a whole.

In this paper were discussed the functions of banking regulation, financial stability and its relation to systemic risk, bank supervision models, micro and macro analysis tools in providing banking supervision, institutions involved in banking supervision worldwide models of supervision.

Subsequently, two models that have marked the evolution of banking supervision in the EU were analyzed and compared - the model developed by UK and the model developed by the Netherlands. The later is an extension of the British one, in fact, but this adds an institution responsible with business conduct. In response to increasing financial instability starting with 1990, banks and other competent authorities became more and more concerned about a deeper understanding of banking vulnerabilities and techniques which can help prevent systemic risk. Thus, states began to be interested in the best practices and some of them have applied the British model. However, later, this model has been replaced by "twin peaks" model in countries like Belgium, Denmark, Sweden, and Austria. This new model is characterized by two major institutions - the Central Bank, as the sole supervisor of all financial institutions and Authority for Financial Markets (AFM) responsible for the supervision of business conduct. Moreover, even the UK was planning in 2011 to move to this alternative.

A comparative approach regarding the main features of prudential supervision systems in the European Union shows that 15 of the 27 Member States has the Central Bank as the body that carries out prudential supervision. The other states have a single supervisory agency which, often, supervises the whole financial system. There are also differences in terms of authority to whom supervisory agencies are responsible, the appointment of the governor of the Central Bank or the president of other supervisory agencies, the mandate of the governor / president or the management board, the dismissal of the governor of the Central Bank or president of the supervisory institution and liability of persons or institutions involved in the supervision process.

Therefore, in the European Union, there are a variety of models of supervision. Some states have adopted integrated supervision, others have adopted unified supervision. Among the latter, some have preferred the classic model of United Kingdom; others have adopted the new model of the Netherlands. This diversity is explained by the specific characteristics of each financial system.

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	Before Recent Crisis	After Recent Crisis
Integrated prudential and conduct-of-business supervision (One Peak)	Austria (2002), Belgium (2004), Germany (2002), Switzerland, Sweden, U.K. (FSA), Hungary (2000), Poland (2006), Japan, Korea, Singapore, Colombia, Nicaragua	Finland (2009), Germany, Switzerland, Sweden, Hungary, Poland, Japan, Korea, Singapore, Colombia, Nicaragua
Separated prudential and conduct-of-business supervision (Twin-Peaks)	Australia (1998), Netherlands (2002)	Belgium (2011), Italy (planned), Spain (planned), France (planned), U.K. (planned), U.S. (with multiple prudential supervisors), Australia (1998), Netherlands (2002)
Unified prudential supervision integrated with Central Bank	Netherlands, Hongkong, Singapore, Switzerland	Belgium (2011), Italy (planned), Spain (planned), France (planned), U.K. (planned), Netherlands, Hongkong, Singapore, Switzerland
Unified prudential supervision outside central bank	Australia, Belgium, U.K. (FSA), Japan, Hungary, Germany	Australia, Japan, Canada, Hungary

Table 1: Worldwide unified supervision
Source: IMF Country Report No. 11/208, July 2011 [26]