Akdeniz University **University of Hamburg**
Institute of Social Sciences **School of Business, Economics and Social Sciences**

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IS FINANCIAL SUPERVISION SUCCESSFUL ENOUGH IN EUROPE?

Joint Master's Programme European Studies Master Thesis

Antalya / Hamburg, 2013

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Akdeniz Üniversitesi
Sosyal Bilimler Enstitüsü Müdürlüğüne,

Hülya DEMİRCİ'nin bu çalışması jürimiz tarafından Uluslararası İlişkiler Ana Bilim Dalı Avrupa Çalışmaları Ortak Yüksek Lisans Programı tezi olarak kabul edilmiştir.

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Tez Başlığı:

Is financial supervision successful enough in Europe?

Onay : Yukarıdaki imzaların, adı geçen öğretim üyelerine ait olduğunu onaylarım.

Tez Savunma Tarihi : 18/12/2012

Mezuniyet Tarihi 31./01./2013

Doç. Dr. Zekeriya KARADAVUT
Müdür

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ACKNOWLEDGEMENTS

I would like to express my sincere gratitude to Ass. Prof. Sükrü Erdem for his supervision, guidance and particularly his explicit comments to help me identify the key points of my thesis. Likewise, I wish to thank Prof. Wolfgang Voegeli for his recommendations for this research and also his suggestions during my whole Master program.

My heartiest thanks to Remzi H. Deda for supporting and encouraging me, with his moral support as well as made this research possible.

I would like to express my deepest gratitude to my mother Ms. Ayse Demirci for her understanding and sensibilities during this research. In addition, my deepest appreciation to my sister Ms. Servin Demirci in helping me to broaden my view during my whole Master program.

ABSTRACT

In recent years there has been an increasing concern with the fragility of the international financial system such as the stock market crash in October 1987 and the recent collapse of the real estate. Therefore, the financial stability framework plays a significant role in the economic environment. Mishkin, with the asymmetric information analysis, puts forward a lender of last resort role (LOLR) should be essential. The analysis denominates to deal with financial crisis. With regard to the past experiences, central banks can take the responsibility of the LOLR role to prevent financial crisis. Besides, when the financial crisis is widespread, cooperation among central banks shall become crucial in order to stop it from spreading from one country to another. The closer cooperation among regulatory authorities and standardization of regulatory requirements ensure the more appropriate regulation.

In the first place, understanding causes of the financial crisis is necessary in case of a repetition of the financial crisis. The common belief on the reasons of a financial crisis is global macro-economic imbalances and financial innovation together with failures in regulation, supervision and corporate governance. In this regard, the ECB, national central banks and supervisory authorities at EU level take an important place whether there is a micro- or macro-prudential supervision. Some alternative approaches have been evaluated for supervision in the European financial system as well. Neither separate institutions nor the integrated ones are not the key points in dealing with the financial crisis. This study focuses explicitly on the importance of the cooperation, coordination and information sharing.

ÖZET

Son zamanlarda uluslararası finansal sistemin kırılganlığı ile ilgili, Ekim 1987 yılında borsa krizi ve yakın tarihli gayrimenkul çöküşü gibi artan bir ilgi var. Bu nedenle, finansal istikrar çerçevesi ekonomik çevrede önemli bir rol oynar. Mishkin, asimetrik bilgi analizi ile son kredi mercii rolünün (LOLR) önemli olacağını ortaya koymaktadır. Analiz finansal krizle basa çıkmayı göstermektedir. Geçmiş deneyimlere dayanarak, merkez bankaları finansal krizi önlemek için son kredi mercii (LOLR) rolünün sorumluluğunu alabilir. Ayrıca, finansal kriz yayıldığında merkez bankaları arasındaki işbirliği krizin bir ülkeden diğerine yayılmasını engellemek için çok önemli olacaktır. Düzenleyici otoriteler ve düzenleyici gereksinimlerin standardizasyonu arasında daha yakin bir işbirliği daha uygun bir düzenleme sağlar.

İlk olarak, finansal krizin bir tekrarı halinde, finansal krizin nedenlerini anlamak gereklidir. Bir finansal krizin nedenleri üzerindeki ortak görüş küresel makro-ekonomik dengesizlikler ve düzenleme, denetim ve kurumsal yönetim başarısızlıkları ile birlikte finansal yeniliktir. Bu bağlamda, AB düzeyinde, Avrupa Merkez Bankası, ulusal merkez bankaları ve denetim otoriteleri bir mikro veya makro-ihtiyati denetimin var olup olmadığı önemli bir yer tutmaktadır. Bazı alternatif yaklaşımlar da denetim için Avrupa finansal sistemde değerlendirilmiştir. Ne ayrı kurumlar ne de bütünleşmiş olanları finansal krizle başa çıkmada kilit noktaları değildir. Bu çalışma, açık bir şekilde işbirliği, koordinasyon ve bilgi paylaşımının önemini üzerinde duruyor.

ABBREVIATIONS

APRA: Australian Prudential Regulation Authority

ASIC: Australian Securities and Investments Commission

BCCI: The Bank of Credit and Commerce International

BOE: Bank of England

CEBS: Committee of European Banking Supervisors

CEIOPS: Committee of European Insurance and Occupational Pensions Supervisors

CESR: Committee of European Securities Regulators

CRA: Credit rating agencies

CRD: Capital Requirements Directive

DB: Deutsch Bank

DG Markt: Directorate-General Internal Market and Services, European Commission

DLR: The De Larosière Report

ECB: European Central Bank

ECOFIN: Economic and Financial Affairs Council

EFC: Economic and Financial Committee

EMI: European Monetary Institute

EMU: The European Monetary Union

EBA: European Banking Authority

EEA: European Economic Area

EIOPA: European Insurance and Occupational Pensions Authority

ESA: European Supervisory Agencies

ESCB: European System of Central Banks

ESFS: European System of Financial Supervisors

ESMA: European Securities and Market Authority

ESRB: European Systemic Risk Board

ESRC: European Systemic Risk Council

EU: European Union

FIH: Financial Instability Hypothesis

FSA: Financial Services Authority

FSC: Financial Stability Committee

HICP: The Harmonized Index of Consumer Prices

HM Treasury: Her Majesty's Treasury

LEGCO: Legal Committee

LOLR: Lender of Last Resort

MoUs: Memoranda of Understanding

NCB: National Central Banks

INTRODUCTION

In recent years there has been a growing concern for the fragility of the international financial system. The stock market crash in October 1987 was a world-wide phenomenon that created fears of a major financial collapse which could severely damage the global economy. The recent collapse of the real estate market has also been a world-wide phenomenon and has led to bankruptcies of major real estate developers both in the United States and abroad.

All of these display the importance of financial stability framework in the economic environment and of preventing, thus, financial crises. Under these circumstances, Mishkin, 1994, with the asymmetric information analysis suggests some policy implementations to prevent financial crises depending on the lender of last resort role (LOLR), discount lending, regulation and policy coordination.

The asymmetric information analysis puts forward that relying on ensuring liquidity to nonbanking sectors of the financial system where asymmetric information problems have improved can lead a lender of last resort role might be essential. According to monetarists, the lender of last resort (LOLR) role ought to be quite narrow. Hence, only if there is an unexpected need on the part of the depositors to withdraw their funds from banks, then the central bank would lend freely to banks. Considering the monetarist view, similar to the asymmetric information view of financial crises denominates a danger in too liberal use of the lender of last activities on the part of central banks. Since the LOLR leads to an increase in liquidity to reduce asymmetric information problems during recessions, it has benefits. However, they generate moral hazard costs. Therefore, only if the LOLR is certainly necessary, the LOLR role should be carefully used to prevent moral hazard from getting worse disputes against such intervention.

Under the asymmetric information analysis of financial crises a reason for discount lending to banks is ensured to avert banking panics. Similarly, it provides a rationale for a "too big to fail" policy where a central bank lends a big, insolvent bank, since a failure of a big bank could lead to an uncertainty in the financial markets which makes a financial crisis more likely. In such a case, during a financial crisis central banks should lend illiquid but solvent banks.

Nevertheless, central bank lending financial institutions could lead to moral hazard incentives as they take on too much risk. Therefore, the central bank should restrict its lending to solvent institutions which do not undertake too much risk. Also such as private financial institutions it is supposed to have access to information about borrowers, thus they could monitor them to mitigate adverse selection and moral hazard problems and vice versa for the

central bank. Central banks' accessing this information can be seen as a way of having a direct regulatory control over these financial institutions. Some central banks, such as the Bundesbank, is against of having a direct regulatory role, since they believe that it will result in political pressures which may hinder their ability to use monetary policy to combat inflation.

The analysis denominates to handle financial crises and it is a must for the international policy coordination. Considering the past experiences, central banks can be responsible for the LOLR role to prevent financial crises, whereas if the financial crisis is worldwide, cooperation among central banks can be significant. When a failure of a main financial institution is forthcoming in one country the central bank in that country must be aware of it and appoint in a lender of last resort role to ensure that the failure does not spread from one institution to other financial institutions in that country. Also it must inform rest of central banks about the forthcoming failure and they also must be ready to act the LOLR role. Moreover, if a central bank thinks its resources are not sufficient to control a financial crisis, it requires demanding for help from other central banks to protect the financial crisis from getting worse and spreading other countries. With regard to highly integrated global financial markets, under the probability of a banking panic in one country spreading another, excessive risk taking by banks should be limited everywhere. Also, considering international banking activities of banks, they must not be able to avoid regulatory oversight. With respect to the 1991 collapse of BCCI, closer cooperation amongst bank regulatory authorities and standardization of regulatory requirements is vital to ensure that all banks are appropriately regulated.

To understand how to prevent a repeat of the financial crisis, it is important to try to understand its causes. The consensus is that global macro-economic imbalances and financial innovation together with failures in regulation, supervision and corporate governance, combined to cause the financial crisis. In the light of this information, in this study first of all, the causes of financial crises are denominated.

As a second part, the linkage between the price stability, the financial stability and the role of monetary policy and supervisory policy in attaining these objectives are revealed, namely, the common acceptance at an international level for the long term is that the stability of prices is the main objective of monetary policy of central banks. The international financial crises identify central banks from several countries to give particular attention to the support of financial stability, since a stable and solid financial system ensures the preconditions for the implementation of an efficient monetary policy. And this efficient monetary policy contributes to the success of the main objective to maintain the stability of the prices.

In the third part, regulation and the supervision in the EU are studied. There is unanimity on the coordination of supervision of the EU financial institutions and markets which is necessary. Strengthened macro- and micro-prudential supervision will contribute to financial systems in the EU. Thus, this ought to ensure a more effective early warning system for reducing systemic risks and contribute to facilitating the operation of the single market in financial systems.

In the following part, the European Central Bank (ECB) and problems with the supervisory power at EU level are discussed. Regarding the current EC Treaty, the opportunity of ensuring any EU supervisory body with the power to assign binding rules or decisions on national supervisors seem little. The creation of any EU body for supervisory authority and comprehensive micro-prudential supervisory roles and powers to organise fiscal resources in the case of crisis, or granting powers to the ECB, is difficult unless it is impossible to bailout financial institutions by national governments. The creation of a single supervisory authority cannot occur if not a facility or burden sharing occur on the bail-out of financial institutions at an EU level.

In the fifth part, the role of the ECB on financial supervision and financial stability management is considered. The recent financial crisis has emphasised the requirement for the ECB to perform a role in maintaining financial stability that is needed to be at the European level. In addition, the ECB has performed to be an effective general lender of last resort (LOLR), as ensuring sufficient liquidity when needed. Regarding the De Larosière Report (2009), the ECB seems to enhance its role in macro prudential supervision, namely, the ECB has a key role in the European Systemic Risk Board. However, it has no direct role for the micro-prudential supervision of individual institutions. A strict relationship between macro and micro prudential supervision is vital for a full and timely flow of supervisory information.

In the sixth part, alternative approaches for supervision in the European financial system are evaluated. The twin peaks approach which is proposed by the Michael Taylor, based on the differences in the purpose of supervision function between financial regulations and financial markets, aims to establish an optimal control. A four peaks approach deals with additionally two aims of the financial regulation denominated in twin peaks approach in a tripartite structure under the condition that regulation and supervision should be coordinated as being parallel to objective. Moreover, further approaches comprise in this study as well. And finally, as a conclusion, in the light of explanations within the paper, this study aims to seek answers on sufficiency of the supervision in EU financial systems.

CHAPTER 1
WHAT IS FINANCIAL CRISIS?

In an economic system, the basic function of the financial sector is funding for real sector activities which is needed. Herewith, financial sector, with all institutions, rules and instruments, has the function of providing funding for real sector units. The main purpose of the actors in financial sector is maximizing own gains, in the light of this fact, financial sector in the global economy plays an active role in an intense competitive environment. Nevertheless, economic unit in financial sector cannot ideally estimate the dynamics of the global macro-economic balances. Also, among economic units, high-gain ambitions, undertaking high-risk, moral hazards, the emergence of manipulation and excessive speculation and other factors affect the occurrence of adverse effects of the financial sector operating mechanisms, thus it can lead to crisis in financial system. In this regard, the definition might be as crisis in financial sector, operation of financial sector activities, and the emergence of unexpected and significantly adversely affected conditions. The definitions in the literature with related to the financial crisis is mainly focused on the loss of the function of providing funding to real sector.[1]

Frederic Mishkin (1994)[2] expressed that the definitions of the financial crisis and the determination for the framework in literature have split into two groups, one of which is monetarists and a more eclectic view propounded by Charles Kindleberger and Hyman Minsky. Monetarists, Milton Friedman and Anna Schwartz (1963) associated to financial crisis with banking panics. They state severe contractions in the money supply have resulted in severe contractions in aggregate economic activity in US. Even if a sharp decline in asset prices and a rise in business failures occur, unless it causes a banking panic and a resulting sharp decline in the money supply, monetarists don't deem these events as a real financial crisis and this situation is demonstrated as a [3]"pseudo-financial crisis". There is no need to be intervened by the government in a pseudo-financial crisis. Under these circumstances, government interventions do more harm than good, because it results in excessive money growth that provokes inflation.

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[1] Oktar, Suat. Dalyanci Levent, (2010), "Financial Crises Theories and Financial Crises in Turkish Economy after 1990" Marmara Üniversitesi, IIBF Dergisi,Cilt XXIX Sayi II, P.1-22

[2] Mishkin, F. (1994) "Preventing Financial: An International Perspective", National Bureau of Economic Research, Working Paper No: 4636, p.2

[3] See more: Schwartz, A.J. (1986) "Real and Pseudo-Financial Crisis", in Capie F, and Wood, G.E. (eds) Financial Crisis and the World Banking System, MacMillon: London: 11-31

M. Bordo and J.L. Lane (2010)[4] express with regard to Friedman and Schwartz, banking panics link with the money multiplier to reduce the money stock, Therefore, since the public fear to convert their deposits into currency, effective banking system causes to massive bank failures, which can be called in today's term "liquidity shock". Besides, M. Bordo admits the financial fragility approach. One of the important factors occurring in financial crisis, with respect to the economic expectations of economic units, is the role of accuracies in investment decisions, accordingly debt decisions. When these accuracies become massive, financial system turns into a fragile situation, and then the panic will be emerged to trigger the financial crisis. Excessive investment trends linked to overoptimistic expectations lead to a pseudo-peak. Nevertheless, this peak turns into a bottom afterwards.

Mishkin (1994) refers to Kindleberger (1978) and Minsky (1972) that the counter-view of financial crisis is shaped by them whose definitions are much broader than monetarists. According to Kindleberger and Minsky; financial crisis may arise from failures of financial and real sector crises, sharp declines in asset prices, disruptions in foreign exchange markets, deflations – disinflations etc.

Minsky, Hyman P. (1992)[5] demonstrates in response to the fluctuations in economy, to strengthen the fluctuations of economic system, in other words, inflation feeds upon inflation and debt-deflation feeds upon debt-deflation. Minsky states that the financial instability hypothesis is a theory of the impact of debt and debt realization in a capitalist system. "In contrast to the orthodox Quantity Theory of money, the financial instability hypothesis takes banking seriously as a profit-seeking activity." Banking sectors make innovations to increase profits. Minsky outlines three genus structures for income-debt structure of economic units. These are hedge, speculative and Ponzi finance. Hedge financing units carry out all their payments by their cash flows. As long as the weight of capital finance in debt structure increases, hedge financing unit also increases. Speculative financing units fulfil their payments by their "income account", even if their cash flows are not sufficient and they need to rollover their liabilities. Ponzi units fulfil neither repayment of capital nor their interests, because of their outstanding debts, cash flow from operations. Future incomes may not be enough to pay even the interest on debts.

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[4] Boldo, M.D., Lane, L. J. (2010), "The Lessons from the Banking Panics in the US in the 1930s for the Financial Crisis of 2007-2008", NBER Working Paper Series, Working Paper 16365

[5] Minsky, H. P. (1992), „The Financial Instability Hypothesis" Work Paper No. 74

The financial instability hypothesis comprises of two theorems. The first theorem is that a system can be both stable and unstable. The second theorem is that during a prolonged period of prosperity, [6]“the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system."

Capitalist economy, without exogenous shocks, as relies on endogenous shocks, generates business cycles. [7]“The hypothesis holds that business cycles of history are compounded out of (i) the internal dynamics of capitalist economies, and (ii) the system of interventions and regulations that are designed to keep the economy operating within reasonable bounds.” [8]In Greece crisis, despite the serious amount of increase in public debt (government expenditure), the same amount of increase didn’t reflect the government revenue because structural reforms (social security reforms; the government increased its commitments to public workers in the form of extremely generous pay and pension benefits) in Greece didn’t materialise. Public debt, financed by external borrowing, has led to severe increase in sovereign debt. In the case of Portugal which is the first EU country violated the Stability and Growth Pact in 2001, public debt and long term recession period aggravated public finance. After the resignation of Prime Minister and political instability and the situation in economy increasingly getting worse, credit rating agencies reduce Portugal’s credit note.

Radonjic, and Miodrac [9](2010) outline that according to the FIH (Financial Instability Hypothesis), as long as the proportion of hedge units are high, the system is stable. Besides, the higher proportion of speculative and Ponzi units mean that more dominant forces lead to system destabilization, herewith, the system becomes fragile, such as; the proportion of absorbing shocks is low, thus, shocks tend to cause financial crisis. Due to increases in debt and stretches in liquidity, the maximum interest rate and units come to a state of more vulnerable, no matter how small increase in interest rates or unexpected decrease in profits are.

According to Mishkin [10](1990) Kindleberger and Minsky’s view on financial crisis, both a strong financial crisis theory, and government interventions as they suggest might be harmful for the economy. In addition, the monetarist view of financial crisis centres on bank panics and their effect on money supply, therewith, it’s scope excessively narrow. Hence, Mishkin puts

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[6] Minsky, H. P. (1992)
[7] Ibid.
[8] EU Ministry, (2011), “Avrupa Birliği’nde Küresel Finansal Krize Karşı Alınan Önlemler ve Birliğin Rekabet Gücünün Arttırılmasına Yönelik Girişimler: “Euro Rekabet Paktı”
[9] Radonjik, O. Zec, M. (2010), “Subprime Crisis and Instability of Global Financial Markets” PANOECONOMICUS, 2010, 2, pp. 209-224
[10] Mishkin, F. (1990), “Asymmetric Information And Financial Crises: A Historical Perspective”. NBER Working Paper, No: 3400

forward the asymmetric information and financial structure that not only exhibits, contrary to monetarist, a broader view but also does not justify, contrary to Kindleberger-Minsky view, directly government interventions. With regard to the asymmetric information, in a financial contract among different parties on the grounds that the allocation of inequity information, uncertainty and moral hazard lead to adverse selection, consequently, it affects effective allocation of resources negatively and under these circumstances there will be a prosperity loss, resulting in financial instability and financial crisis eventually. Mishkin (1994) expresses that "the factors causing financial crisis are: 1) increases in interest rates, (2) stock market declines, (3) increases in uncertainty, (4) bank panics, and (5) an unanticipated decline in inflation." In this regard, the importance of bankers and financial intermediaries are related to the effective allocation of financial resources. If the misallocation of resources arises, the allocation of resources for non-productive investments decreases. Consequently, misallocation of financial resources, after a while, affect adversely for rollover. Due to asymmetric information, moral hazard and adverse selection, uncertainty will increase. Under these circumstances interests rise, accordingly, increased debt costs lead to raise deterioration in balance sheets, thus financial crisis will be arisen. As I mentioned above, in Greece, because of the misallocation of resources in public expenditure, public debt is arisen.

Mishkin (2009)[11] points out the common features between past and recent financial crisis. The three factors of current crisis are: "1) mismanagement of financial innovation, 2) an asset price bubble that burst, and 3) deterioration of financial institution balance sheets."

Financial innovation is an important instrument for making the financial system more efficient. Nonetheless, considering the recent financial crisis, the financial innovations of subprime mortgages and structured credit products turned into a destructive effect. They did not handle crucial problems, such as originate-to-distribute model, and incentives for prospering credit risks analysis is also quite weak. The housing price bubble aggravated to the weakening of underwriting standards in the subprime mortgage market. When the housing price bubble burst in 2007, the decrease in housing prices caused that the value of the house fell below the amount of the mortgage.

Considering the economic growth of Ireland based on housing and business sector, burst has led to impairment loss especially on banking which restructures a large amount of housing loans suffers. Intensive saving measures and dismissals, right after crisis, in public sector increased

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[11] Mishkin, F.S. (2009), "Is Monetary Policy Effective During Financial Crises?", NBER Working Paper Series, No:14678

banking panic. Increased debt level due to the large bailout packages makes sovereign debt impossible.

CHAPTER 2
THE COMPLIANCE OF PRICE STABILITY, FINANCIAL STABILITY and FINANCIAL EFFICIENCY

The importance of the twin goals of price stability is obvious, also the stability of the financial system as well. What is also needed to be understood is the relationship between them. This issue is important, since arrangements for the pursuit of price stability require guaranteeing not to jeopardize the stability of the financial system. And the financial system's weaknesses should not hamper the effective operation of monetary policy. This issue is also timely, since the new Basel Capital Accord concentrates on the systemic risk issue. In addition, we can consider some countries whose responsibility for the supervision of financial institutions has been transferred from the central bank to an independent regulatory authority on behalf of the central bank itself taking a more responsibility for overall systemic stability. The important thing is the link between monetary and prudential policies rather so much the institutional division of responsibilities, and how to develop arrangements that can support monetary and financial stability as well, despite the formal assignment of policy tasks. The link between monetary policy and financial stability perform in both directions and take many forms, thus this is a quite complex situation.[12]

2.1 Price Stability

The Maastricht Treaty provides the ECB with a clear mandate for maintaining price stability. "Price stability is defined as a state in which the general level is literally stable or the inflation rate is sufficiently low and stable, so that considerations concerning the nominal dimension of transactions cease to be a pertinent factor for economic decisions." (By the ECB)

There is almost a consensus about the general definition for price stability considering the announcement of this definition by the Government Council in 1998; "price stability is an annual variation of the Harmonized Index of Consumer Prices (HICP) more than 2% and maintaining this price stability on the medium term". (Regarding to the further clarifications in 2003 is under (but near) 2%.)

[12] Crockett, Andrew, 2001, "Monetary policy and financial stability" Speech by Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, given at the Fourth HKMA Distinguished Lecture, held in Hong Kong, 13 February 2001. P.1

Isărescu[13] underlines there are various definitions of price stability; price stability is related to the aggregate level of prices, which measured through indexes. When the value of money is maintained in time or the abrasion is very low in purchasing power, the concept of monetary stability associates to the concept of price stability. For instance; central banks which adjust the strategy of direct inflation targeting, numeric target for price stability can be a fluctuation band or a certain percentage with or without fluctuation interval.

Table 2.1 Numerical Definitions Of Price Stability

Country	**Target Definition**	**Target Index**
Czech Republic	3	CPI
Hungary	3	CPI
Iceland	2.5 ± 1.5	CPI
Norway	2.5	CPI*
Sweden	2 ± 1	CPI
United Kingdom	2	CPI (HICP)
Euro area	< 2	CPI (HICP)

Sources: Berg [14](2005), Truman [15](2003) and national central bank

Over the past few decades, price stability has been accepted as the main objective of a central bank, a precondition for attaining overall stability in an economy for good reasons. [16]First of all, considering experiences from the past and economic studies, monetary policy plays a role for improving economic prospects and raising the living standards of citizens by maintaining price stability permanently. Secondly, in economy only price level is influential on the theoretical foundations of monetary policy which is the reason of why price stability is the only feasible objective for a single monetary policy over the medium term. As long as price stability has no positive influence, monetary policy is not able to apply any permanent impact on real variables. Because of the goal of price stability, higher economic output is promoted. Moreover, the only way to minimize the time-inconsistency of monetary policy is an institutional commitment to price stability. Due to price stability goal in the long run, lower employment will not be triggered. In addition, an institutional commitment to price stability can lead to promote that the government responsible fiscally for good monetary policy. Besides, dealing

[13] ROMAN Angela, BILAN Irina 2009, “The Monetary Policy And The Financial Stability In The Context Of Globalization” See more: Isărescu, M.C., Price Stability and Financial Stability, 2006, at http://www.bnr.ro/PublicationDocuments.aspx?icid=6885, accessed on July 5, 2009. P.145

[14] Berg, Claes, 2005. “Experience of inflation-targeting in 20 countries”. Sveriges Riksbank Economic Review, 1/2005. P.23

[15] Truman, Edwin M., 2003. Inflation Targeting in the World Economy. Washington DC: Institute for International Economics at the report of Wynne, Mark A., 2008, “How Should Central Banks Define Price Stability?” p.28

[16] HERBEI Marius, DUMITER Florin, (2009) “The Commpliance Of Price Stability, Financial Stability And Financial Efficiency” p.78

with the large budget deficits is difficult for a government, because their implements can lead to inconsistency on price stability goal; such as raising taxes or printing money to pay for goods and services causes more inflation.

As an adverse view, Orphanides [17](2011) points out that central banks have failed to achieve maintaining price stability with regard to the experiences in the past. As long as the central bank plays an insufficient role for this goal, ultimately overall stability is affected adversely, which happened in Europe, 1970-1980, when inflation was allowed to be ingrained. And the idea of possibility in facilitating better outcomes considering economic growth and employment, inflation was allowed for in some states. Nevertheless, this idea led to stagflation.

2.2 Financial Stability

In the last years, maintaining financial stability and fostering financial development more broadly became a main objective of central banks. Because of being part of a larger economic, social and political system financial system for financial system, the increase in financial crises, their negative effects on financial markets and the macroeconomic perspectives, but also due to the economic and social costs that they entail.

Contrary to price stability there is no generally valid definition or a synthetic indicator for its qualification. ECB defines financial stability that „the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities" [European Central Bank, 2009a, 9].

Boldea, Gheorghe, Ivanovici, Strezariu [18](2010) define that financial stability emerges as a feature of the financial system consists of the financial market-institutions and their correlated infrastructure. Due to interactions among components – market, institutions and infrastructure - the others (overall economy) might be affected. Nonetheless, as long as the system works well relying on how operates its core function, even existence of problems which derived from one of the components, any threat will not jeopardise overall stability. Hence, there is no mandatory for all components as performing at or near maximum in any time.

[17]Orphanides, Athanasios (2011), "New Paradigms in Central Banking?" pp. 3-4
[18] Boldea Bogdan, Gheorghe Roxana Maria, Ivanovici Daniela Cecilia, Strezariu Iulia Ana-Maria, (2010)"Monetary Stability Versus Financial Stability In Adjusting The Real Economy" p.679

Defining the concept of financial stability under the financial stability reports of some central banks as instances;[19]

Foreword at the Financial Stability Report, 2007, of Czech Republic, defines "financial stability as a situation where the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, while showing a high degree of resilience to shocks."[20]

Foreword at Financial Stability Review, November, 2005, of Germany, denominates "financial stability as the financial system's ability to perform its key macroeconomic functions well, including in stress situations and during periods of structural adjustment."[21]

Foreword at Financial Stability Report, April, 2005, of Hungary, states, "Financial stability is a state in which the financial system, including key financial markets and financial institutions, is capable of withstanding economic shocks and can fulfil its key functions smoothly, i.e. intermediating financial resources, managing financial risks and processing payment transactions."[22]

Herbei and Dumiter [23](2009) define that financial stability is a condition on which the financial system has the ability of withstanding shocks and sorting out of financial imbalances. The resilience of financial system to risk and vulnerabilities is vital, since it alleviates the likelihood that "shocks to the financial system, or the unravelling of financial imbalances, can lead to disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities."

In the light of these explanations, identification of the major sources of risk and vulnerability is essential for safeguarding financial stability that is, evaluating if the financial system leads to expedite a smooth and efficient reallocation of financial resources from savers to investors and assessing if prising properly and handling efficiently of financial crisis. Due to the feature of a forward-looking dimension of financial stability, capital allocation inefficiencies or shortages in pricing and management of risk can negotiate future financial system stability, accordingly, economic stability. To rely on monitoring financial stability under a systemic perspective and an extensive manner is essential.

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[19] At the report of ROMAN Angela, BILAN Irina (2009), p.146
[20] Ibid
[21] Ibid
[22] Ibid
[23] HERBEI Marius, DUMITER Florin, (2009) p.80

The financial stability framework is exemplified, by Herbei and Dumiter that is a "stylized view of factors affecting financial system performance".

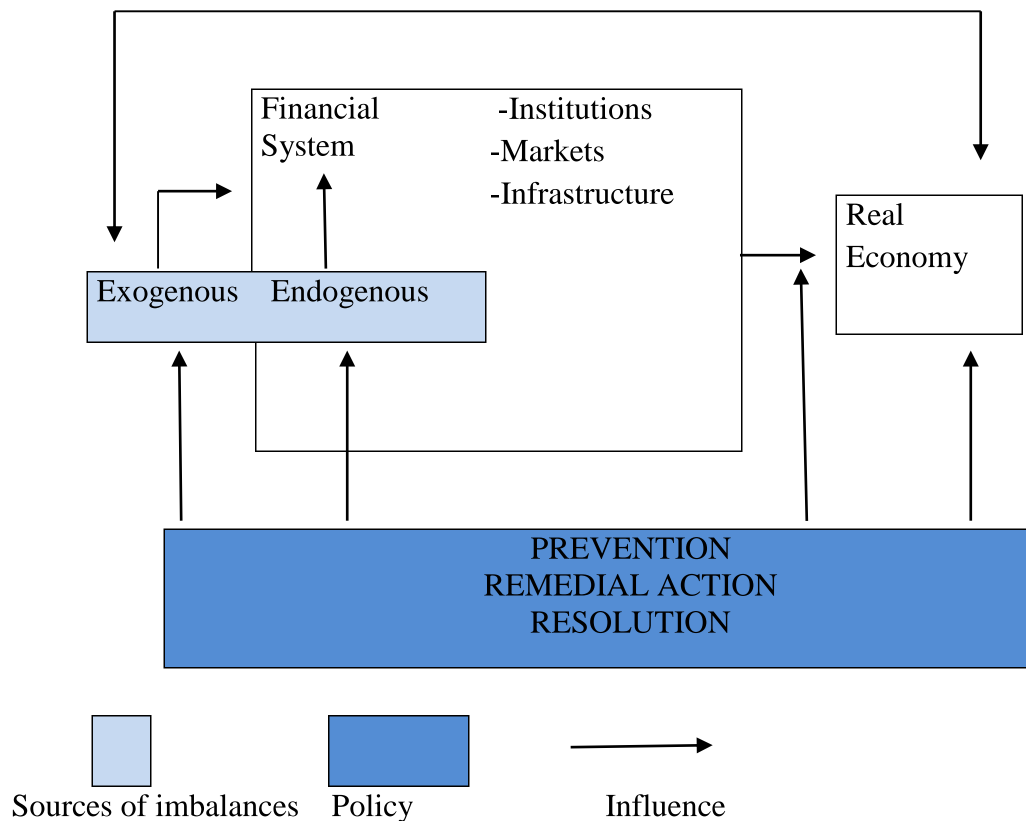

Figure 2.1 Stylized View of Factors Affecting Financial System Performance
[24]**Source:** Houben, Kakes and Schinasi, 2004

Since the existence of market deficiencies is related to public sector policy, finance facilitates resources allocation, dealing with risks and absorbing shocks in the economic system. With respect to this figure, financial system associates to the real economy and policy. In the financial system, disruptions derived from outside of the system make a precise distinction between imbalances. Mostly, policy implication differences stimulate this distinction. The interaction between analyses and policy formulation and implementation is essential for the financial-stability framework.

[24] At the report of Herbei and Dumiter, 2009, p.81

2.3 The Role of Monetary Policy – The Contributions of Price Stability to Financial Stability

Monetary stability and financial stability are closely interrelated. [25]There is a widely consensus on the idea that monetary policy, by maintaining price stability, makes a significant contribution to maintaining financial stability. For instance; precluding deflation leads to fostering the maintenance of financial stability, as preventing an essential increase in the real burden of presence of debts. The monetary policy tools might also contribute to the maintenance of financial stability, in order to facilitate to estimate the effect of accurate financial decisions, as in the finalization of a variable rate mortgage loan.

According to Herbei and Dumiter (2009) monetary policy has the ability of safeguarding to the real purchasing power of money and the real disposable income of households. Stable prices facilitate recognizing changes in relative prices for people. Hence, markets are more available for the efficient resource allocation. Furthermore, due to the reduction in the uncertainty about the future inflation and future policy rates, improving price stability effect leads to diminish to the risk premia within the interest rates. In addition, as the maintenance of price stability, monetary policy makes it easier for banks and borrowers to prevent potential balance sheet problems which linked to unexpected but permanent deflation. The reason behind these problems is the increase in the real cost of debt-servicing which turning to unable to repay their debt, due to unexpected deflation, accordingly it leads to financial crisis. Finally, financial market participants believe that monetary policy leads to reduction in asset prices or exaggerate the economy in answer to a financial crisis.

There is a broad consensus on the idea that volatility of the inflation can be harmful for the stability of the financial system. Borio and Luwe [26](2001) state that if an unexpected decrease in inflation occurs, this leads to rise in the real value of outstanding debt.

In literature there are two approaches with respect to the relation between price stability and financial stability, that is, the conventional approach and new environment hypothesis. The conventional approach was indicated by Schwartz.

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[25] Aucremanne, l., ide, S. (2010), "Lessons from the crisis : Monetary policy and financial stability" p.8
[26] Borio ,Claudio and Lowe, Philip, (2002) "Asset prices, financial and monetary stability: exploring the nexus"

Bordo and Wheelock [27](1998) define that "The Schwartz Hypothesis is not a theory of financial crisis, but rather an explanation of how price level instability can lead to or exacerbate financial distress and possibly lead to a crisis."

Schwartz states that high inflation leads to unproductive lending. As the asymmetric information model of crises, it might exacerbate for lenders to evaluate the true riskiness of borrowers. Due to misconstruction inflation of increases in relative prices, lenders could be promoted to make unproductive loans; however, disinflation can lead to deter lending, by worsening it to discern relative price changes from movement of aggregate price level. In addition, high inflation causes that many tax system facilitate to the attractiveness of leveraged asset purchases.

Bordo, Dueker and Wheelock [28](2001) investigated the conventional approach relying on statistical data. In the light of their analysis, the most crucial banking crisis emerged in periods illustrated by crucial aggregate prices instability. Their studies show, on the basis of empirical evidence on UK, that aggregate price shocks had a significant influence on financial conditions. Due to deflationary shocks, price level aggravated financial embarrassment, since inflationary shocks encouraged expansionary financial conditions.

Goodfriend [29](2001) argued that monetary policy has the ability of preventing deflation and handling the zero bound to reconstruct welfare when a deflationary shock is in question. As Roman and Bilan (2009) referred that Borio and Lowe have the similar view on that, financial imbalances can occur and also increase in an economic environment identified by price stability. According to these authors in the exacerbation of financial imbalances, the major task of a credible monetary policy expresses the "credibility paradox" which was formulated also in the literature "new environment" hypothesis of monetary policy. Boldea et al [30](2010) state that as controlling at low levels a new economic environment is improved and financial stability is not ensured anymore. Having a low and stable inflation can lead to emergence of an extreme confidence, thus the assumption of substantial risks will be also promoted.

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[27] Bordo Michael D., Wheelock David C. (1998), " Price Stability and Financial Stability: The Historical Record" p.41

[28] Bordo, Michael D. , Dueker, Michael J., Wheelock David C. (2001) "Aggregate Price Shocks And Financial Stability: The United Kingdom 1796-1999", NBER Working Paper Series No: 8583, pp.43-52

[29] Goodfriend, Marvin, (2001), "Financial Stability, Deflation, and Monetary Policy", pp.143-145

[30] Boldea Bogdan, Gheorghe Roxana Maria, Ivanovici Daniela Cecilia, Strezariu Iulia Ana-Maria, (2010), pp.679-681

Roman and Bilan [31](2010) noted that there is no empirically verification basis on "credibility paradox" hypothesis of monetary policy, until today, however, the relation between price stability and financial stability occupy an important place for central banks. 2007 international crisis in the mortgage credit market shows maintaining financial stability in some cases is essential compared to the price stability. Under this circumstance, at least for short term, maintaining price stability can be adopted by a monetary policy to accept priority measures for maintaining financial stability. As long as the absence of financial stability is in question, neither the increase of monetary policy efficiency can be guaranteed, nor can the long term price stability be guaranteed.

2.4 The Role of Financial Stability and Efficiency for the Conduct of Monetary Policy

Herbei and Dumiter [32](2009) noted that due to developments in the financial system efficiency, the transmission efficiency of the policy rates on interest rates and asset prices increase eventually. Considering some statistical data because of the increased deregulation, integration and innovation, accordingly the euro area financial sector effectiveness was developed. Hence, recently the relation between policy rates and bank lending in the euro area has expedited.

Financial instability can lead to a reduction in the monetary policy efficiency, such as, under a strict financial instability condition, decline in policy rates might not lead to strong effects compared to normal conditions, the reason behind this is that increasing risk premium protect lending rates against falling, or credit restriction results from a general reluctance on the part of the banks to lend. At worst, if the decisions of monetary authority lead to in the name of the decline to the costs of credit do not achieve in developing credit market conditions. Financial efficiency whose basis on further development of capital markets can also help carry out of monetary policy, as it develops the availability and quality of information. An increased availability of financial indicators provide better estimations for private sector expectations and, considering future developments in real growth, profits, inflation and interest rates, enhanced assessment of uncertainties. This information can improve the formulation and carrying out monetary policy. With the intention of acquiring suitable financial market information relies on understanding of the determinants of the level and assessment of risk premium in asset returns.

The authors underline that trade-off between price stability and financial stability is not discussed in the long run. There can be some circumstances where such a trade-off appears over

[31] Roman and Bilan, 2010, P-147
[32] Herbei and Dumiter, 2009, P.82

the short to medium term. The essential issue is that the conduct of monetary policy on asset price misalignments might cause risks to financial stability. As referring the analysis of the Bank for International Settlements, not only the conduct of strict monetary policy on price stability in the short-run compared to the long run may entail risks, but the potential outcomes of financial instability also may be disregarded in the long-run price stability.

2.5 The Role of Monetary Policy and Supervisory Policies

Long-term complementary between the goals of price stability and financial stability does not imply that, even if the maintenance of price stability is important, it does not have the power in itself to maintain financial stability. Nevertheless, according to the main approach, monetary policy does not have more active role, whereas it took into account that a proper prudential policy in terms of regulation and supervision must conduct to financial stability primarily.[33]

Paul De Grauwe and Daniel Gros [34](2009) noted as referring to the financial crisis of 2007-08 that the conventional approach of price stability should be both primary and effectively objective of a central bank. Consequently, there is a consensus on during the last decade, central banks including the ECB, has succeeded in the maintenance of price stability. Nonetheless, keeping inflation low could not hinder a financial crisis from exploding. That issue calls to mind if financial stability has significance objective for the central bank. Before the breakout of the crisis, the general view was that the price stability would lead to a reduction on the risk of financial stability. Furthermore, the supervisors and regulators are mainly responsible for the maintenance of financial stability.

In most countries, the central bank plays an important role in the management of the financial system. Whereas, while nowadays it is widely accepted that "the fundamental task of the Central bank is to preserve the value of the currency" [35](Fischer, 1997), the assignment of other “optional tasks", such as the responsibility on banking supervision and regulation, has been subject currently at the centre of a relevant policy debate.[36]

Carmine Di Noia and Giorgio Di Giorgio (1999) denominate that this situation lead to differences among financial systems. Monetary policy and banking supervision merely in a few countries are designated for a single agency (the Central Bank). These two functions are

[33] L. Aucremanne, S. Ide , 2010, “Lessons from the crisis : Monetary policy and financial stability”, p.10
[34] De Grauwe ,Paul and Gros, Daniel, (2009), “A New Two-Pillar Strategy for the ECB”, p.1
[35] See more: Fischer S., (1997), "Central Banking: the Challenges Ahead – Financial System Soundness", Finance and Development, March.
[36] Ioannidou, Vasso P., (2003), “Does monetary policy affect the central bank’s role in bank supervision?” and Di Noia, Carmine and Di Giorgio, Giorgio, (1999), “Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?”

separated as in many other countries, thus agency/agencies designate/s for banking supervision, ultimately in combination with the central bank. To be effective, a system of banking supervision must [37]"have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources"

An issue brings into light among the academicians whether the combinations of two functions under the same agency result in weak banking supervision and adversely affect monetary policy. Considering developed countries, Central banks are not any longer "monopolist" in banking supervision; in other words, the separations of the two functions become more common. In 1997, as renamed Financial Services Authority (FSA) was assigned to banking supervision. Hence, all financial markets and intermediaries are supervised by the FSA.

In the European Monetary Union (EMU), the principle of separating monetary policy and banking supervision duties has placed, since the beginning, in the structure of the European Central Bank (ECB). To coordinate and carry out monetary policy in the Euro zone, banking supervision duties authorize to the ECB, as allowing the duties for banking supervision with the national authorities.

Nevertheless, Carmine Di Noia and Giorgio Di Giorgio [38](1999) noted considering the empirical results assessments, “banks seem to be more profitable if Central bank supervise them but show higher staff costs and issue less bonds, which could be interpreted as an indicator of lower efficiency.” They could not obtain a certain evidence for the separation between monetary policy and bank supervisory agencies in their analysis. Conversely, the development of financial intermediaries, moral hazard problem and cost accountability promote the separation. Besides, it could be helpful to explain who is responsible for paying the costs of monetary policy and banking supervision.

[37] Principle no. 1 of the core principles for banking supervision, Basle Committee, 1997.
[38] Di Noia, Carmine and Di Giorgio, Giorgio, 1999,” Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?” p.28

Table 2.2 Monetary Policy and Bank Supervisory Agencies

Country	**Monetary Policy Agency**	**Bank Supervisory Agency**	**Status**
Austria	National Bank of Austria	Ministry of Finance	Separated
Belgium	National Bank of Belgium	Banking and Finance Commission	Separated
Denmark	Danmarks Nationalbank	Finance Inspectorate	Separated
Finland	Bank of Finland	Bank Inspectorate, Bank of Finland	Separated
France	Banque de France	Banque de France, Commission Bancaire	Separated
Germany	Deutsche Bundesbank	Federal Banking Supervisory Office	Separated
Greece	Bank of Greece	Bank of Greece	Combined
Ireland	Central Bank of Ireland	Central Bank of Ireland	Combined
Italy	Banca d'Italia	Banca d'Italia	Combined
Luxembourg	Luxembourg Monetary Institute	Luxembourg Monetary Institute	Combined
Netherlands	De Nederlandsche Bank	De Nederlandsche Bank	Combined
Portugal	Banco de Portugal	Banco de Portugal	Combined
Spain	Banco de España	Banco de España	Combined
Norway	Norges Bank	Banking, Insurance and Securities Commission	Separated
Sweden	Sveriges Riksbank	Swedish Financial Supervisory Authority	Separated
Switzerland	Swiss National Bank	Federal Banking Commission	Separated
United Kingdom	Bank of England	Financial Services Authority (from 1998)	Separated

[39]**Source:** Di Noia, Carmine and Di Giorgio, Giorgio, 1999

[39] Di Noia, Carmine and Di Giorgio, Giorgio, 1999, p.32

CHAPTER 3
REGULATION and SUPERVISION IN THE EU

To attain financial sector stability, sufficient financial regulation and supervision are vital. Regardless of their significant role, both failed to avert or moderate the financial crisis. Since financial regulation endeavours to establish rules that guarantee a credible and resilient financial sector, it has shown to comprise several gaps and legal vacuum.

Financial supervision, on its behalf, seeks to monitor whether the financial sector obeys the relevant rules. When financial stability is in a risky situation, supervisors are capable of producing a sufficient answer. The recent crisis has illustrated not to be sufficient of revealing or giving warning of emerging problems. The incompatibility between the financial sector and supervision composed the supervisory failures. The supervisory structure in the EU showed incapable of handling to the integration of the financial sector. By 2005, the EU's all banking activity became a cross-border nature, mostly surpassing the levels of integration that were seen in the American and Asian-Pacific financial sectors. Although this integration and inter-dependency improved, the financial supervision in Europe had been still almost completely a member state affair. Hence, an obvious asymmetry has risen between the financial system and supervisors. The asymmetry between supervision and financial system integration does not seriously hinder effective supervision, whereas it demands strong cooperation between the national supervisors. As a result of this, the supervisory failures lead to requirement of major reforms which brought about a set of reforms that came into force in January 2011, under the De Larosière Report.[40] In this part, by focusing on the powers and limits of the different supervisory levels, it aims to evaluate the financial system.

3.1 The Definition of Regulation and Supervision

Referring to the House of Lords, EU Committee 14th Report [41](2009), supervision has to rely on monitoring and enforcement and on regulation with rule making. Clive Maxwell, Director for Financial Stability at HM Treasury, described regulation as "actual hard rules that are written down" and supervision as "the application of those rules to a particular firm or group of firms and going in there and making sure that they are following those rules".[42] For instance, the EU's Capital Requirements Directive (CRD) transfers the Basel II rules into EU law. UK

[40] Verhelst, Stijn, 2011, "Renewed Financial Supervision in Europe – Final or Transitory?" p.9
[41]House Of Lords European Union Committee, (2009) " The future of EU financial regulation and supervision-14th Report of Session 2008–09" p.11
[42] Ibid. p.11

national supervisors, the Financial Services Authority (FSA), are responsible for implementing these rules. The FSA provides that financial institutions abide to the capital rules which define in the CRD.

3.2 The Purpose of Regulation and Supervision

The main goal of regulation and supervision is maintaining stability and prompting confidence in the financial system so as to guarantee solvency and soundness of financial institutions, in other words prevention of systemic risk. The conduct of business provides an efficient, trustworthy and effective functioning of financial markets, consisting of a fair and transparent market process.[43] Furthermore, regulation and supervision aim to safeguard investors, borrowers and other users of the financial system against excessive loss risks and also other financial damage that might derive from failure, deceiving, corruption and other misconduct on the part of providers of financial services.[44]

Identifying the line which should be between statutory and self regulation, since promoting soundness and generating prosperity must lead to reach balance. Regulation when not required might be harmful for the functioning of financial market and prevent innovation and economic growth.[45]

Lawson, J., S. Barnes and M. Sollie (2009) state that if regulation is not well designed, it may cause to increase instability, due to regulatory arbitrage or promoting undue risk-bearing. In addition, neither lenders have certain information about the riskiness of borrowers within the investment projects, nor regulators and supervisors have definite information about balance sheets or market conditions of the bank riskiness. Taking on precisely cost-benefit analysis of banking regulation cause to be occasional within the instability terms and spread regulation costs.

Obeying the rules correctly from a bank or financial institution standpoint, which regulation is in question, should be guaranteed by supervision. Hence, they deal effectively with their risks and they abide by precise minimum standards. The system of bank and financial institutions should also be considered totally to identify risks affecting the whole system. Supervisors'

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[43] Holopainen Helena, (2007), "Integration of financial supervision" p.12 and Lawson, J., S. Barnes and M. Sollie (2009), "Financial Market Stability in the European Union: Enhancing Regulation and Supervision", OECD Economics Department Working Papers, No. 670, OECD Publishing.
[44] Lawson, J., S. Barnes and M. Sollie, 2009, p.7
[45] See more Alain de Serres, Shuji Kobayakawa, Torsten Sløk and Laura Vartia, (2006), "Regulation Of Financial Systems And Economic Growth In Oecd Countries: An Empirical Analysis" at Lawson, J., S. Barnes and M. Sollie, 2009, p.8

decisions can be binding and have sanctions on those institutions, such as imposing penalties, whoever do not follow the rules. (House of Lords European Union Committee, 2009)

House of Lords denominates to the work of a supervisory body as consisting of four separate roles:[46]

"• Licensing—the granting of permission for a financial institution to operate within its jurisdiction;

• Oversight—the monitoring of asset quality, capital adequacy, liquidity, internal controls and earnings;

• Enforcement—the application of monetary fines or other penalties to those institutions which do not adhere to the regulatory regime; and

• Crisis management—including the institution of deposit insurance schemes, lender of last resort assistance and insolvency proceedings."

3.3 Micro-prudential Supervision

Prudential supervision concentrates on [47]the solvency and confidence and soundness of financial institutions, however, the conduct of business supervision is related how financial firms carry out business conduct with their customers.

Caravelis [48](2010) notes that micro-prudential supervision examines how individual institutions conduct supervision under the assumption that asset prices, market/credit conditions and economic activity are relied on their decisions. According to this assumption, although the decisions are taken individually, they are quite small and do not have any noteworthy effect on the economy. Consequently, they do not have a dominant status. Lotte Schou-Zibell, Jose Ramon Albert, and Lei Lei Song go further [49](2010) since the assumption of risk is exogenous for micro-prudential dimension, individual institutions commonly have merely small effect on the economy. Hence, the micro-prudential dimension analyses individual institutions, products and markets. The micro-prudential approach, in terms of risks of individual institutions, is bottom-up.

[46] The House of Lords, 14th Report, 2008-09, pp.11-12

[47] Martin Schüler, 2003, "How Do Banking Supervisors Deal with Europe-wide Systemic Risk?", pp.2-3

[48] Georges Caravelis, 2010, "The EU Financial Supervision in the Aftermath of the 2008 Crisis: An Appraisal", EUI Working Paper, Robert Schuman Centre For Advanced Studies, p.3

[49]Lotte Schou-Zibell, Jose Ramon Albert, and Lei Lei Song, 2010, "A Macroprudential Framework for Monitoring and Examining Financial Soundness" pp.3-6

The De Larosière Report (DLR) [50] (p.38) states main objective of micro-prudential supervision:

“to supervise and limit the distress of individual financial institutions, thus protecting the customers of the institutions in question. The fact that the financial system as a whole may be exposed to common risks is not always fully taken into account.” Therefore, micro-prudential supervision can fail to classify risks that appear at the systemic level.

According to the House of Lords[51] report, “micro-prudential supervision is the day-to-day supervision of individual financial institutions. The focus of micro-prudential supervision is the safety and soundness of individual institutions as well as consumer protection.”

Hence,[52] if the general objective is achieved by the consumer safety through the extenuation of risks, financial stability turns into a public good. In addition, if it is internalised by the financial institutions, it turns into a Money Externality. The DLR also mentions this public good externality: “micro-prudential supervision attempts to prevent (or at least mitigate) the risks of contagion and the subsequent negative externalities in terms of confidence in the overall financial system”.

3.4 Macro-prudential Supervision

Contrary to the micro-prudential supervision, macro-prudential supervision focuses on the financial system as a whole to limit the chances of system wide distress and prevent essential losses in terms of real output. The macro-prudential dimension, compared to micro-prudential dimension, assumes that risk is in part endogenous with regard to the conduct of the financial system. Hence, the macro-prudential dimension considers the interactions within the system as a whole and permit for endogeneity or feedback. The macro-prudential supervision is also top-down in its calibration of prudential instruments.[53]

The House of Lords defines [54](2010) that “macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy.”

[50] The DLR examined the causes of the financial crisis and made 31 Recommendations to repair the EU Regulatory regime, enhance the EU Supervisory structure, and promote financial stability at the global level.
[51] The House of Lords 14th report, 2009, “The future of EU financial regulation and supervision”p.12
[52] Georges Caravelis, 2010, p.3 referring to the DLR report p.38
[53] Lotte Schou-Zibell, Jose Ramon Albert, and Lei Lei Song, 2010, Borio, Claudio, 2003, Towards a macroprudential framework for financial supervision and regulation?
[54] The House of Lords, 14th 2008-09, p12

Trichet [55](2009) underlines; why macro-prudential supervision is desirable for the European Union. Recent crisis has exposed the primary significance of systemic risk, whose key features are, "first, contagion; second, the build-up of financial imbalances and unsustainable trends within and across the financial system; and third, the close links with the real economy and the potential for strong feedback effects." In the light of the information, the goal of macro-prudential dimension is, after defining sources of systemic risk and recommending remedial action, to alleviate and avoid systemic risks to financial stability in the EU on the basis of the defined vulnerabilities and systemic risk assessments.

The table 3.1 shows the differences between micro-prudential and macro-prudential supervision which are explained above.

Table 3.1 The Macro- and Micro-prudential Perspectives Compared

	Macro-prudential	**Micro-prudential**
Proximate objective	Limit financial system-wide distress	Limit distress of individual institutions
Ultimate objective	Avoid output (GDP) costs	Consumer (investor/depositor) protection
Model of risk	(in part) endogenous	Exogenous
Correlation and common exposures across institutions	important	Irrelevant
Calibration of prudential controls	In terms of system-wide distress; top-down	In terms of risks of individual institutions; bottom-up

[56]**Source:** Borio, Claudio

3.5 EU Financial Supervisory Structure - European System of Financial Supervisors

As a result of the crisis following the recommendations of the De Larosière Report, the establishment of a new framework was proposed by European Commission that composed of: the European Systemic Risk Board (ESRB), which is an EU level body responsible for the macro-prudential supervision of the EU financial system, with a secretariat function provided by the ECB; and the European System of Financial Supervisors, including the existing national supervisory authorities and three new European Supervisory Agencies, namely, European

[55] Jean-Claude Trichet, 2009, "Macro-prudential supervision in Europe", Text of The Economist's 2nd City Lecture by Mr Jean-Claude Trichet, President of the European Central Bank, London,

[56] Borio, Claudio, 2003, "Towards a macro-prudential framework for financial supervision and regulation?" Table 1, p. 2

Banking Authority, European Securities and Market Authority and European Insurance and Occupational Pensions Authority, to be constituted at the micro-financial level for the banking, securities and insurance sectors.[57]

European System of Financial Supervision (ESFS)

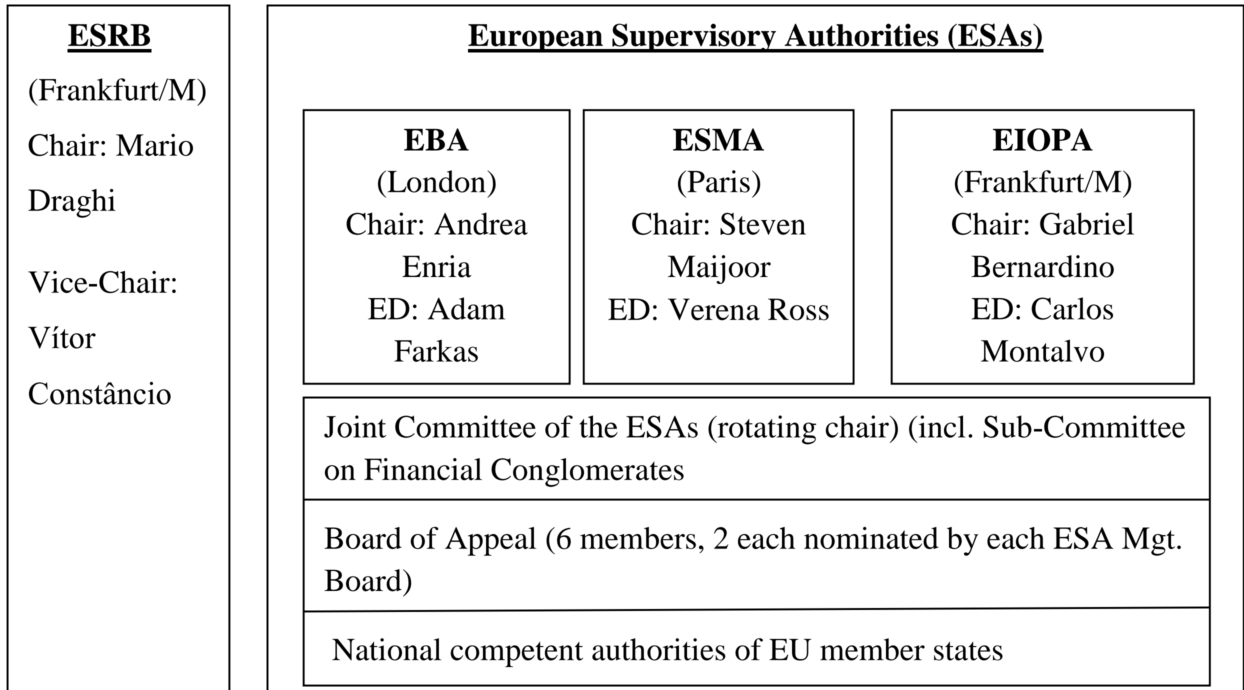

Figure 3.1 European System of Financial Supervision (ESFS)

[58]**Source:** DB Research, 2011

3.5.1 European Systemic Risk Board (ESRB)

The ESRB is the only EU level macro-prudential supervisor, as remaining without a legal personality. The ESRB consists of a General Board, a Steering Committee, a secretariat and two Advisory Committees.

[57] ECB, 2010, "Recent Developments In Supervisory Structures In The EU Member States (2007-10)", p.1
[58] DB Research, 2011, p.3

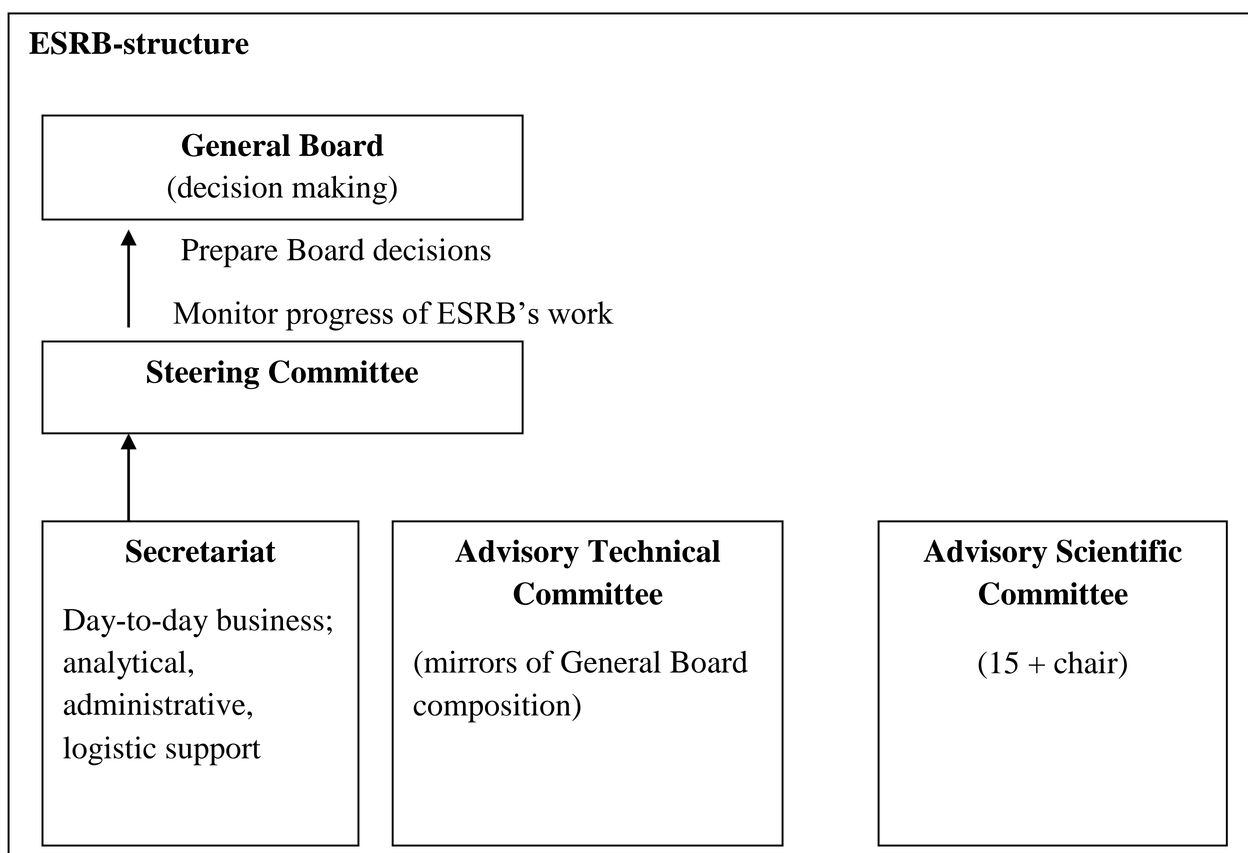

Figure 3.2 ESRB Structure

[59]**Source:** DB Research, 2011

The General Board is the central decision-making body of the ESRB. It meets at least four times a year. It comprises the president and the vice-president of the ECB, the governors of the national central banks of member states, a member of the European Commission, the chairpersons of the three European Supervisory Authorities, the chair and two vice-chairs of the Advisory Scientific Committee, the Chair of the Advisory Technical Committee. Furthermore, the president of the Economic and Financial Committee (EFC), representatives of each of the national supervisory authorities and the head of ESRB secretariat also attend the meeting, however, they have no right to vote (non-voting members).[60]

The role of the Chair of the General Board has an essential position in the ESRB. In the legislative negotiations, contrary to non-euro area countries, the president of the ECB is demanded as a chair of the General Board by the parliament. Therefore, as a bargain, the president of the ECB chairs the General Board sole its first five years. In the name of ensuring counterbalancing in the euro area chair, the first vice-chair should be non-euro area

[59] Ibid. p.5

[60] Verhelst, Stijn, 2011, and Council of The European Union, 2010, "Financial supervision: Council adopts legal texts establishing the European Systemic Risk Board and three new supervisory authorities", PRESSE 303, p.22

representative and the second vice-chair yearly replaces between the chairpersons of EU micro-prudential supervisory bodies.[61]

The Steering Committee sets meetings and decisions of the General Board. It comprises the chair of the General Board, the first vice-chair of the General Board, the vice-president of the ECB, four other members of the General Council of the ECB who are also members of the ECB's general council, a member of the European Commission, the president of the Economic and Financial Committee, the chairpersons of the three European Supervisory Authorities, the Chair of the Advisory Scientific Committee, the Chair of the Advisory Technical Committee.

The secretariat is financed and staffed by the ECB, rather the ESRB. The ECB is even empowered to assign the Head of the ESRB secretariat. Considering the dominant role of ECB in ESRB, non-euro area member states have denominated that the ESRB is disproportionately focussed on the euro area.[62]

The General Board and the Steering Committee have two advisory committees, namely, the Advisory Scientific Committee and the Advisory Technical Committee, as ensuring specific input to the ESRB.

The Advisory Scientific Committee consists of 15 non-governmental experts, the chair of the Advisory Technical Committee and the head of the ESRB secretariat. The non-governmental experts are comprised of academics, representatives from the industry, trade unions and consumer organisations[63]. Considering its mandate, the Advisory Scientific Committee is to review and design macro-prudential analysis and policy tools[64].

The ESRB aims to supervise the financial system as avoiding or lessening systemic risk which defines with respect to the Regulation as “a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy[65]“.

The ESRB implements that; supervision of the financial system; emit warnings and recommendations; ensure follow-up on its recommendations and report and cooperate with other supervisors.

[61] Ibid.
[62] See more: Treasury Committee of the UK House of Commons, Opinion on Proposals for European Financial Supervision, Session 2008-09, Sixteenth Report, 2009, pp. 19-20.
[63] Article 12 of Regulation (EU) No 1092/2010, op. cit. footnote 57.
[64] ESRB, Mandate of the Advisory Scientific Committee of the European Systemic Risk Board, 20 January 2011
[65] Article 2(c) of Regulation (EU) No 1092/2010, op. cit. footnote 57.

As aforementioned, although the main objective of the ESRB is to supervise and identify potential or existing systemic risk in the financial system, the ESRB has no enforcement power to carry out direct supervision, such as; asking for information from individual financial institutions. And this might prove a serious weakness and at the least increases some legitimate doubts considering its effectiveness. A certain hierarchy is in question for acquiring information. The ESRB uses but existing data available at the EU level. When this is not sufficient, it can demand information through the ESAs and afterwards central banks, national supervisors or national statistical authorities. In addition, when these options fail, the ESRB can ask for information from member states itself as a last way. Consequently, the ESRB is merely permitted to acquire information on individual financial institutions under the condition of receiving the precise authorisation by the relevant EU micro-prudential supervisor.[66]

As the role of the ESRB is to monitor and evaluate potential threats to the stability of the financial system, where necessary, it emerge risk warnings and recommendations for remedial action and monitor their implementation. Warnings and recommendations can be addressed to the EU as a whole as well as to one or more member states, or to one or more of the European supervisory authorities (ESAs), or to one or more national supervisory authorities. Nevertheless, the ESRB cannot address warnings or recommendations to financial institutions.[67] Moreover, under any circumstances, the ESRB report the Council and the Commission of all warning and recommendation. Besides the ESRB is required to publish an annual public report, however, it does not have to ensure information on its non-public work, not even in an ex-post manner. This might lead to the main ESRB’s work ambiguous in front of the general public, as critically hindering its public responsibility.

The ESRB is limited as becoming its warnings and recommendations are non-binding. Hence, it uses “name and shame” option to increase the effects of warnings and recommendations, such as during the panic in financial market.

According to “act or explain” mechanism, countries will have to justify their reaction whether they fail to act on ESRB risk warnings. Hence, Begg [68](2009) evaluates that the ESRB’s lack of formal powers do not need to avoid it from acting in a credible and reliable manner. “If the ESRB judges the reaction to be inadequate, it will inform the addressees, the

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[66] Verhelst, Stijn, 2011, p.23
[67] Article 16 of ibid.
[68] See more: Begg, Iain. 2009. “Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis.” Journal of Common Market Studies 47:1107–1128

Council and, where relevant, the ESA concerned. On a case-by-case basis, it could decide to make the recommendations public after informing the Council."[69]

3.5.2 European System of Financial Supervisors

The European System of Financial Supervisors consists of national supervisory authorities (existing foretime) and three new European Supervisory Agencies to be established for the banking, securities and insurance sectors.

European Supervisory Authorities (ESA) – Micro-prudential Supervision

The EU micro-prudential supervision bodies comprise ~~of~~ three European Supervisory Authorities, a Joint Committee of ESAs and a Board of Appeal. Figure which is below shows an overview.

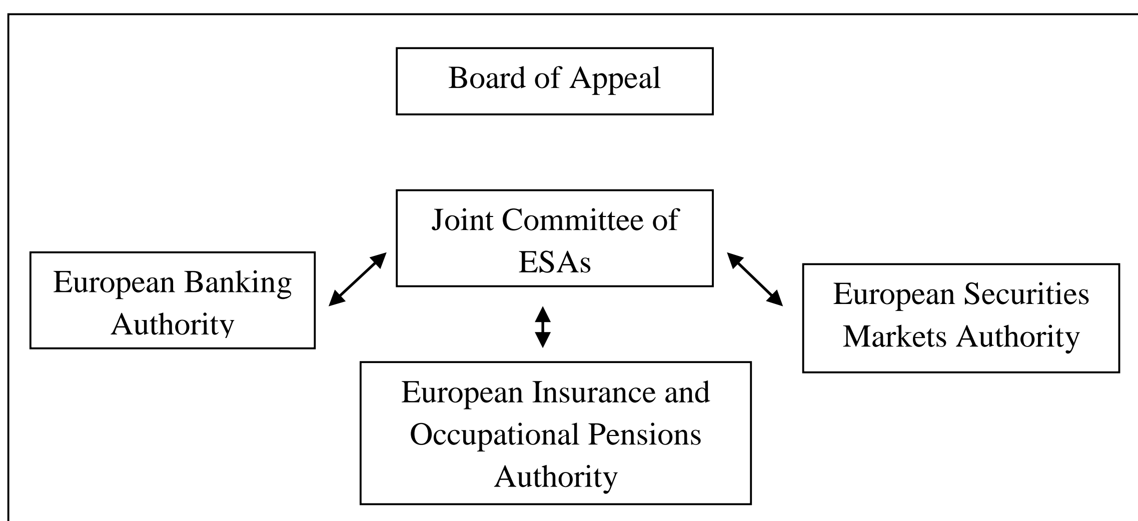

Figure 3.3 European Supervisory Authorities (ESA)- Micro-prudential supervision

[70]**Source:** Verhelst, Stijn, 2011,

The three new European Supervisory Agencies (ESAs) – EBA, ESMA and EIOPA – which replace three former Lamfalussy level 3 Committees, (CEBS, CESR and CEIOPS; together dubbed the ―"3L3"). ESAs established as EU agencies and the three ESAs are community bodies with legal personality, unlike the 3L3. Hence, this enables to practice a precise degree of independence from the EU Institutions[71] and they are directly liable to the Council and the European Parliament.

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[69] Council of The European Union, 2011, 10737/09 (Presse 168), p.9
[70] Verhelst, Stijn, 2011, "Renewed Financial Supervision in Europe – Final or Transitory?" p.18
[71] See more: ANDOURA, S., TIMMERMAN, P., Governance of the EU: The Reform Debate on European Agencies Reignited, EPIN Working Paper, nr. 19, 2008, p. 5.

Each of the ESAs manages a particular subset of the financial sector, namely:

•the European Banking Authority (EBA): in charge of the banking sector[72], located in London;

•the European Insurance and Occupational Pensions Authority (EIOPA): in charge of the insurance and occupational pensions sector, including pension funds[73], located in Frankfurt;

•the European Securities and Markets Authority (ESMA): in charge of the securities sector and financial markets[74], located in Paris.

ESAs consist of high level representatives of all of the member states' supervisory authorities. National authorities keep in charge on the day-to-day supervision of individual firms, Together with them; ESAs shape the micro-prudential section of the supervisory system. Furthermore, a Joint Committee of the ESAs provides consistency of regulation across sectors and to coordinate information sharing between the ESAs and the ESRB.[75]

The ESAs are in charge of providing a single set of harmonised rules and coherent supervisory practices are applied by supervisory authorities of the member states, namely national authorities. The ESAs do not have mandate to implement day-to-day supervision of financial institutions, which is the only responsibility of national supervisory authorities. Nevertheless, under the three defined circumstances, the ESAs are allowed to take decisions referring to individual institutions, which would dominate over previous decisions taken by national empowered authorities:[76]

- With respect to demand on the European Commission, the EP, the Council, any national supervisory authority, the Banking Stakeholder Group or on its own initiative, the ESAs might examine asserted breaches of EU law by national authorities. Under the condition of the national competent authority is non-compliance with EU law or it does not fulfil a Commission opinion as requiring it to take necessary action and as a result of these

[72] See Article 1(2-3) of Regulation (EU) No 1093/2010 of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJ L 331, 15.12.2010, pp. 12-47, hereinafter EBA Regulation.
[73] See Article 1(2-3)Regulation (EU) No 1094/2010 of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, OJ L 331, 15.12.2010, pp. 48-83, hereinafter EIOPA Regulation.
[74] See Article 1(2-3) of Regulation (EU) No 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/ EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010, pp. 84-119, hereinafter ESMA Regulation.
[75] Deutsche Bank Research, 2011, "Financial supervision in the EU- Incremental progress, success not ensured" and Council of The European Union, 2010, pp.9-10
[76] Ibid. P.10

non-compliance, market disruptions expose, the ESAs are allowed to directly take an individual decision on a financial institution.

- When the emergency situations are subject to, ESAs might accept decisions requiring competent (national) authorities to act or issue a decision directly applicable to an individual financial institution. The emergency situation would have to be confirmed by the Council, in consultation with the ESRB and the European Commission. If national authorities do not comply, under particular conditions, the ESAs can take an individual decision addressed to financial institutions.
- Under the condition of mediation has failed, the ESAs might take binding action in the events of lasting disagreements between national authorities. If national authorities do not comply, under particular conditions, the ESAs can take an individual decision addressed to financial institutions. Verhelst [77](2011) notes that "both in counteracting breaches of EU law and the settling of disagreements, the ESAs' actions are only to ensure compliance with EU law. This limits the scope of these competences. Even so, it is to be underlined that the ESAs' binding powers in the matter imply a significant step-up in the role of EU level supervisors."

In response to the countries concerned about the ESAs power a safeguard clause was introduced into the Regulations. The clause limits the fiscal consequences of ESA decisions in emergency situations and the settlement of disagreements. The safeguard clause stipulates that an ESA decision shall not impinge on a Member States' fiscal responsibilities, thus limiting the fiscal consequences of the ESAs' decisions. In particular this is related with a bail out clause in question. During the financial crisis, when financial institutions required refinancing, Member States were hardly ever to agree on burden sharing arrangements. Because of the safeguard clause, the ESAs will be little more than a forum for such agreements.[78] And the Council of the EU (November 2010) underlines that [79]"any binding decision taken by the ESAs will be subject to review by the EU courts."

The ESAs ensures to promote consistency in the EU law application among colleges of supervisors. With regard to this situation, ESAs are allowed to gather and share information,

[77] Verhelst, 2011, P.42
[78] Verhelst, 21011 p.50, and DB Research, 2011, pp.10-11
[79]The Council of the EU, November 2010, P.11

foster risk assessments and harmonise EU-wide stress tests to evaluate the elasticity of financial institutions.[80]

Differences amongst ESAs

The ESAs' institutional set-ups are similar, however, their competences are different from each other. In comparison with the other two ESMA has more essential place for regulation, namely with a rule-setting role it regularly refers to EU legislation, such as derivatives markets. Whereas, EBA[81] relies on prudential supervisory subjects and it does not direct supervisory powers excluding the exceptional situations aforesaid. ESMA has widely responsibility of competences, spanning securities, securities markets, clearing houses, fund managers, and credit rating agencies (CRA). Furthermore, ESMA has a direct supervisory role, namely, empowering and supervising right to CRA is vested with ESMA. Hence, ESMA is the only structure in ESA that has direct supervisory power. As a result of this, in the name of demanding information, reaching investigations and performing on-site inspections, the power will be given to ESMA. It might be sense, if powers were given ESMA for other pan-European structures and organisations, such as clearing houses. Nevertheless, the responses coming from national authorities and member states to such opinions are not found favourable, because the direct supervisory powers' transfer to the EU level is not even now welcoming for many national authorities and member states. [82]

Masciandro, Nieto and Quintyn [83](2011) state that it should be also noted that in the case of existing disagreement and expediting delegation agreements among national authorities, the EBA is given powers by the regulation to affect and get involved in the national supervisory processes through mediation in colleges of supervisors. Moreover, in order to coordinate regulatory frameworks as issuing technical standards, guidelines and recommendations. Nevertheless, considering crisis management, the Council gives the power to ascertain an emergency situation. Also, in order to harmonise stress tests to evaluate the elasticity of financial institutions providing coherent methodology, EBA receives a technical role.

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[80] Ibid.
[81] Considering the proposal of the Commission as receiving the support of ECOFIN on June 9, 2009 and the European Council adopted it as the European Supervisory Framework for the future during the June 18–19, 2009 Summit. The ECOFIN proposal establishing EBA (Council of European Union, 2009) summarizes mandates, tasks and governance arrangements for this supranational supervisory authority.
[82] DB Research, 2011, p.13
[83] Masciandaroa, Donato; Nietob, Maria J.; Quintync Marc, 2011, "Exploring governance of the new European Banking Authority—A case for harmonization?" p.11

3.5.3 Joint Committee

The Joint Committee comprises the chairpersons of the ESAs and the chairperson of any sub-committee established by the Joint Committee, especially the Sub-Committee on Financial Conglomerates.

The Joint Committee of ESAs aims to provide cross-sectoral consistency and operates as a forum for cooperation among the ESAs. In particular, major areas for consistency and joint positions comprise; financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risk and vulnerabilities, retail investment products, measures combating money laundering, cooperation with the ESRB and enhancing the relationship between the ESRB and the ESAs. [84]

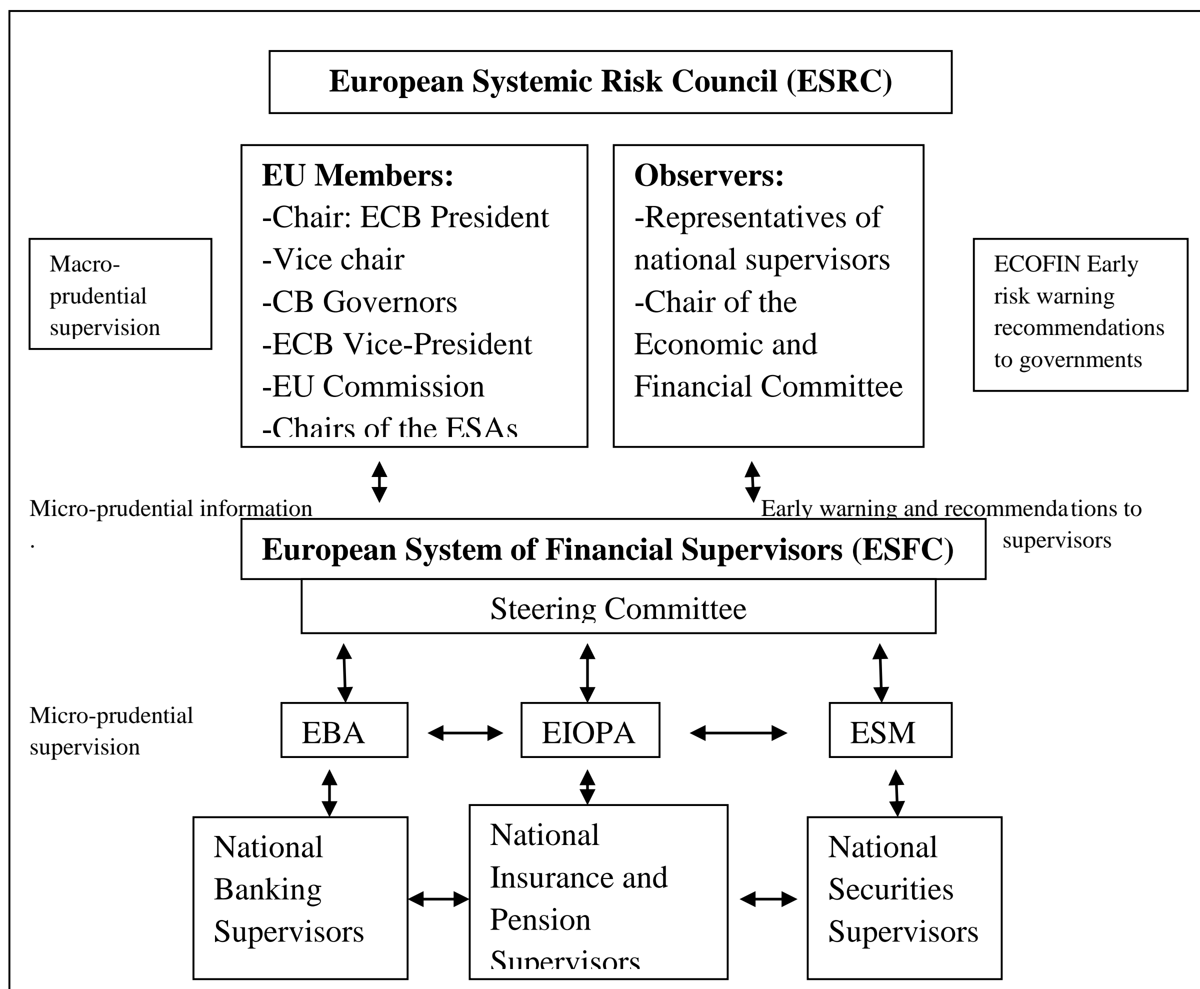

Figure 3.4 European Systemic Risk Council (ESRC)

[84] Schinasi, Garry, 2011, "Financial-Stability Challenges in European Emerging-Market Countries", Policy Research Working Paper 5773 , p.19

[85] Commission on "European financial supervision", COM (2009), 252, 27.05.2009, based on the Laroisiere report (2009), and adopted in accordance with the ECOFIN's conclusion of 9 June 2009

3.5.4 National Central Banks (NCB)

Although the legislative reforms underline EU level supervisors, EU supervisors create merely a small amount of the European supervisory landscape. Indeed, actual supervision of financial institutions is implemented by other supervisors. Considering cross-border supervision, the role of colleges of supervisors has been reinforced. However, there is no substitution for these colleges and the EU supervisory bodies over the crucial role of national supervisors.

3.5.4.1 Cross-border Colleges of Supervisors (Consolidated Supervision Model)

The consolidated supervision model, namely, the consolidating (or home) supervisor has the ultimate responsibility for all European operations of a bank. As guaranteeing their various interest and proficiency, "Colleges of Supervisors" are established in order to gather the supervisory authorities of all countries.[86]

The Colleges of Supervisors' establishment rely on two Directives which are adjusted Capital Requirements Directive (CRD) and Solvency. Their objective is to monitor "all cross-border banking institutions established in the EU". As a result of the financial crisis, colleges of supervisors have become mandatory for multinational financial institutions[87]. Since, more than 100 supervisory colleges had been established in the European Economic Area[88].

Considering these Colleges, sharing local market condition, coordinating cross-border issues are occurred. Theoretically, decision making relies on a compromise, however, a dilemma is in question, and the consolidated supervisor has the ultimate decision.

The main advantage of the consolidated supervision model is to promote supervisory knowledge-sharing and cooperation. And also it leads to clear structure for definite decision-making and creates current practices and structures; therefore, it permits an evolutionary response to increasing cross-border activities of banks. While this model sole includes supervisors with a direct responsibility for a given institution and does not establish a new

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[86] Aerdt Houben, Iskander Schrijvers and Tim Willems, 2008, "The Supervision of Banks in Europe, The Case for a Tailor-made Set Up", Vol.6/No.4, Occasional Studies, pp.13-15

[87] Article 131a of Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions [recast], OJ L 48, 30.3.2010, pp. 1-252. This obligation applies to financial institutions that are supervised by a consolidating supervisor; see Article 42a of the Directive.

[88] CEIOPS, List of groups for which a College of supervisors is in place, February 2010, Retrievable on: https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/20100201-CEIOPS-List-of-groupswith-a-college-of-supervisors-in-place.pdf. , Verhelst, 2011, Caravelis, 2010

supervisory level, it limits the weight of coordination attempts and prevents supervisory repetition. Furthermore, a single point of contact at the consolidated supervisor expedites the management of harmonisation attempts and financial crises. Besides all of these, since the final decision relies on the College of Supervisors, there is no certainty for the interests of sub-consolidated supervisory authorities whether will be always adequately considered. Furthermore, the consolidated supervisor is merely responsible for financial stability in its home region; therefore, in ultimate supervisory decisions the results of the failure of a branch or subsidiary may not be sufficiently represented.[89]

After all, Verhelst, [90]2011, underlines that the rise of colleges of supervisors are important as close cross-border cooperation amongst supervisor is essential. However, their weakness is related to the character of cooperation. Identifying the colleges mandatory is a first step further of closer cooperation and another crucial step is ensuring the ESAs with mediation competences. Nonetheless, both do not ensure effective cross-border supervision. In order to accomplish this, there would be more binding forms of supervisory coordination taken into account.

3.5.4.2 National Supervisors

The recent crisis has led to encourage essential changes in national supervisory structures. Member states mostly improved their supervisory models, advanced macro-prudential supervision and increased the central banks' role. Nevertheless, the structure, competences and independence of national supervision implementation differ in Member States.[91]

Some countries concentrate on supervision across banking securities and insurance. Occasionally, the central bank has been in charge for that, such as in the Netherlands and adversely as in the United Kingdom, the authority has been assigned to a separate supervisory agency. For other countries, separate sectoral supervisors are kept. Considering [92]Masciandara's empirical results, there is an inverse correlation between the central bank involvement in prudential supervision and the degree of integration of the sectoral supervision. Nevertheless, considering the separation of prudential supervision and central banking, it does not mean that valuable information is not shared by regulators and central bankers. Table states

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[89] Aerdt Houben, Iskander Schrijvers and Tim Willems, 2008, pp.13-15
[90] Verhelst, 2011, p.57
[91] Ibid. p.58
[92] See more: Masciandaro, D. (2005, forth "Financial Authorities? A Political Economy Approach" in (D. Masciandaro ed.), Central Banks and Single Financial Authorities in Europe, Edward Elgar.

that apart from Luxemburg and Denmark, all central banks of the EU member states have some mechanism to acquire ~~to~~ supervisory information.[93]

Table 3.2 National Supervisors

Country	No institutions responsible for prudential supervision (banks, insurance and securities)	The central bank is the bank supervisor	Central bank has access to banks' prudential information	Comments
Austria	1	No	Yes	CB is involved in the management of the banking supervisor and carries out monitoring in specific areas
Belgium	2	No	Yes	CB is involved in the management of the banking supervisor
Denmark	1	No	No	Separate supervisory agencies
Finland	2	No	Yes	CB is involved in the management of the banking supervisor and carries out monitoring in specific areas. The CB
France	6*	No	Yes	CB is involved in the management of the banking supervisor. The CB and banking supervisor share resources
Germany	1	No	Yes	The CB carries out monitoring in specific areas (off-site). The CB and supervisor share resources
Greece	3	Yes	Yes	
Ireland	1	No	Yes	The unified supervisor is an autonomous part of the CB. The latter and the single supervisory authority share IT and other resources
Italy	3	Yes	Yes	
Luxemburg	2	No	No	
Netherlands	2	Yes	Yes	The CB supervises the banking and securities markets. After January 2005 it will also supervise the pensions and insurance industries
Portugal	3	Yes	Yes	
Spain	3	Yes	Yes	

[93]Garcia, Gillian G. H., Nieto Maria J., 2005, "Banking crisis management in the European Union: Multiple regulators and resolution authorities" p.8

Sweden	1	No	Yes	CB is involved in the management of the banking supervisor. In addition the CB and the single supervisor have signed MoU to share
United Kingdom	1	No	Yes	The CB and the single supervisor have signed an MoU to share information

[94]**Sources:** ECB Monthly Bulletin and authors at the report of Garcia et al, 2005

** Responsible institutions: Banking Commission; Committee on Banking and Financial Regulation; Committee for the Establishment of Credit Institutions and Investment Companies; Financial Markets Authority; Insurance Supervision Commission; National Credit and Securities Council; and the Ministry of Economic Affairs and Finance.*

The implementation of day-to-day micro-prudential supervision is the major objective of national supervisors, such as confirming whether individual financial institutions are followed by the related rules and in sound financial health. Hence they can ensure the majority in implementation of supervision with relevant work. Both national supervisors are responsible for the bulk of supervision objective, and they play a central role in the cross-border and European supervisory bodies. For instance; colleges of supervisors pretend to be related to national supervisors. The EU institutions are controlled by the national representatives. Thus, the cross-border and EU level institutions are not supranational institutions. Although they have a crucial role, national supervisors' limits still remain. The meaning of the improved competences of EU micro-prudential supervisors is that national supervisors can be rejected. In addition, the national supervisors' flexible powers will decrease due to the single rule book and the coordination of supervisory practices. National supervision will be adjusted more gradually according to the EU level. Nonetheless a shift national to European supervision is unrealistic from now on.[95]

[94] ECB Monthly Bulletin and authors at the report of Garcia et al, 2005, p.9
[95] Verhelst ,2011, p.58

CHAPTER 4
EUROPEAN CENTRAL BANK (ECB) and PROBLEMS WITH THE SUPERVISORY POWER AT EU LEVEL

The recent financial crisis has brought forward to reform the structure of financial supervision in the EU. One of the failures has been propounded that caused to the crisis was the lack of linkage between macro- and micro-prudential supervision. In order to detect macro-prudential and systemic risks to the financial systems, there was a failure. As mentioned below, the establishment of a macro-prudential supervisory authority within the EU, to denominate risks which affect the overall financial system in the EU single market. The difficulty about the structure and powers of such a body has been still controversial. Furthermore, the failure of micro-prudential supervision appeared to detect and moderate risks through the supervision of individual institutions. This applies to institutions, like banks, which have been regulated in the past, and institutions, like credit rating agencies, which have been hardly regulated or not regulated at all. The proposals under the aim of reconstruction of the EU system of financial supervision mainly depend on the principles of national competence and cooperation. They comprise essential implications for the future of the single market in financial markets, especially the supervision of cross-border financial institutions. [96]

4.1 European Central Bank (ECB)

The European Central Bank (ECB), following the provision of the EC Treaty, was established on June 1, 1998. It replaced with the European Monetary Institute (EMI). The ECB, as the core of the central banking system called the European System of Central Banks (ESCB), is in charge of conducting monetary policy in the euro area. The ECB has a legal personality with decision making powers and a separate budget, as a supranational institution.[97]

Relying on the EC Treaty, the ESCB is assigned to implement central banking functions for the euro. Nevertheless, since the ESCB lacks of legal personality, due to differentiated levels of integration in EMU, the ECB and National Central Banks (NCB) play the main role for the euro area countries. They implement the major functions of the ESCB as called Eurosystem. The Eurosystem consists of the ECB and the NCBs of the EU Member States which have

[96] The House of Lords, 14th Report, 2008-09, p.27

[97] Cecchetti, Stephen G., Schoenholtz, Kermit L. 2008, “How Central Bankers See It: The First Decade of ECB Policy and Beyond” NBER Working Paper, No 14489; Scheller, Hanspeter K., 2004, “The European Central Bank - History, Role and Functions”

adopted the euro (currently 16[98]). The European System of Central Banks (ESCB) consists of the ECB and the NCBs of all 27 EU Member States.

The ECB has three decision-making bodies: the Governing Council, the Executive Board and the General Council. The Governing Council and the Executive Board govern the eurozone. The General Council is a body that consists of the 27 Member States of the EU.

The fundamental decision making body of the ECB is the Governing Council, which has an essential role for the Eurosystem as taking crucial decisions. It consists of the six members of the Executive Board and the governors of the NCBs of the member states that adopted the euro. The Executive Board is in charge of all daily basis decisions.

The General Council comprises the president and the vice-president of the ECB and the governors of the NCBs of all 27 EU Member States. Thus, the General Council ensures representation for all EU Member States whether they have adopted the euro or not and will exist on condition that some Member States have not adopted the euro. The Treaty, the Statute of the ESCB and the relevant Rules of Procedure determine the functioning of these decision-making bodies.

The ESCB primarily aims to maintain price stability in the eurozone as in Article 105.1 of the Treaty which refers to the basic tasks to be implemented via the ESCB. Technically, these tasks employ sole to the Eurosystem and comprise:
• to define and implement the monetary policy of the euro area;
• to conduct foreign exchange operations consistent with the provisions of Article 111;
• to hold an manage the official foreign reserves of the Member States of the euro area; and
• to promote the smooth operation of the payment systems. [99]

Other ECB tasks comprise:
•" the authorisation to issue and the issuance of euro banknotes;
• the collection of the statistical information necessary for the tasks of the Eurosystem (Article 5 of the Statute);

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[98] Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.
[99] The European Central Bank, the Eurosystem, the European System of Central Banks, 2009, http://www.ecb.int/pub/pdf/other/escb_en_weben.pdf, Art. 105of the EC Treaty

• advisory tasks (article 105.4 of the Treaty); and
• international cooperation (Article 6 of the Statute)"[100]

As one of the main tasks of the ESCB, the Maastricht Treaty did not accept a proposal to dictate prudential supervision. Considering the ultimate edition of the Treaty and the ESCB Statute, the references to supervision are restricted.[101]

4.2 Problems with Supervisory Powers at EU Level

Observers refer to the fiscal authority's national jurisdictional area and the EC Treaty as substantial difficulties to any proposals for transferring supervisory responsibilities to an EU body. To ensure the ECB particularly with any supervisory responsibilities, the difficulty is composed by the divergences amongst the euro area, the EU single market in financial services and the European Economic Area (EEA), while all EU Member States and also the EEA Member States are affected by the responsibilities.[102]

4.2.1 EC Treaty

None of the ESAs has micro-prudential supervisory powers, except for ESMA's aforementioned limited powers vis-à-vis CRAs. The major difficulty behind the EC Treaty is in the powers which any EU supervisory body would hold. With regard to witnesses[103], giving binding powers to any EU body was not possible considering the EC Treaty, with the exception

[100] House of Lords, 2009, p. 29
[101] Ibid.
[102] Ibid.
[103] See more: Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB 2009 ECON meeting with national parliaments, Financial crisis: Where does Europe stand? Brussels, 12 February 2009. The exception of insurance undertakings was mentioned as an obstacle for the ECB having a supervision role by DG Markt:
The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only; Association of British Insurers (ABI), Association of Chartered Certified Accountants (ACCA), * Bank of England, ** Mr Graham Bishop, * Ms Sharon Bowles MEP, European Parliament, ** British Bankers' Association (BBA), * Mr Lee C. Buchheit, Cleary Gottlieb Steen & Hamilton LLP, City of London Corporation, * Committee of European Securities Regulators (CESR), Confederation of British Industry (CBI)
Council of Mortgage Lenders (CML), Deutsche Bank, * European Banking Federation, ** European Commission
* Financial Reporting Council, Financial Services Authority (FSA), Fitch Ratings, * French Permanent Representation to the European Union, * Professor Charles Goodhart, London School of Economics, Professor Christos Gortsos, University of Athens, Mr Will Hopper, former Member of the European Parliament, Banking Commission - International Chamber of Commerce, * M Jacques de Larosière, Chairman of the High-Level Group on Financial, Supervision in the EU, London Investment Banking Association (LIBA), Professor Jean-Victor Louis, Brussels University, Moody's Investor Services, ** Lord Myners, Financial Services Secretary to HM Treasury, and Mr Clive, Maxwell, Director of Financial Stability, HM Treasury, * Mr John Purvis MEP, European Parliament, * Mr Marke Raines, Taylor Wessing LLP, * Mr Antonio Sáinz de Vicuña, European Central Bank
Professor René Smits, University of Amsterdam, Standard and Poor's, Which?, Wholesale Markets Brokers' Association and the London Energy Brokers' Association

of limited powers for ESMA and of Article 105 which ensures to transfer some supervisory powers to the ECB. Since national competence is still responsible for supervision, any EU body has the power to take binding decisions over national supervisors. [104]

Besides, if member states want, Art. 105.6 EC Treaty ensures the power for them to give the ECB particular tasks in the area of financial supervision. With regard to the Article, the Council of Ministers might assign the ECB with "specific tasks concerning policies relating to prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." Sáinz de Vicuña, the Chairman of the Legal Committee (LEGCO) of the ESCB, states that including the 27 National Central Banks of the European Union, General Council of the ESCB can apply the Art 105.6. Under this circumstance a provision could be applicable to both eurozone and non-eurozone.[105]

To assign the ECB with its supervision tasks, the Article 105.6 would not force to change in treaty, whereas, would require consensus in the Council of Ministers and approval by the European Parliament in order to enter in force. The UK showed its tendency is against to assigning the ECB with powers via Article 105.6. The Article leads to diminish the change of attaining a common agreement in Council. Mr Sáinz de Vicuña underlines that, insurance companies from the scope of supervisory tasks are eliminated through the Article 105.6. Due to effectiveness of financial institutions in the banking and the insurance sectors, this may lead to increase in the risks of supervisory division.[106]

Bini Smaghi[107] evaluates that the exclusion of insurance companies from Article 105.6 "would not prevent the ECB from being attributed with responsibilities related to the supervision of financial conglomerates as the related supervisory regime … does not regard the direct supervision of insurance undertakings."

It is underlined, by the House of Lords, that considering the EC Treaty there is possibility of ensuring any EU supervisory body with the power in order to give binding rules or taking

[104] Ibid.
[105] Ibid.
[106] Ibid.
[107] Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB 2009 ECON meeting with national parliaments, Financial crisis: Where does Europe stand? Brussels, 12 February 2009. The exception of insurance undertakings was mentioned as an obstacle for the ECB having a supervision role by DG Markt

decisions on national supervisors. Furthermore, the use of Article 105.6 demands consensus and some Member States is against its activation.

4.2.2 Fiscal Authority

According to most of aforesaid witnesses the national jurisdictional area of the fiscal authority ensures essential matters for proposals in order to give supervisory powers to any EU body, such as the ECB. British Bankers' Association states on condition that the bailing out responsibility of a failed institution relies on national scope, that national authorities will be responsible for micro-prudential supervision. Lord Turner of Ecchinswell, chairman of the Financial Services Authority, stated in the Committee[108] that governments would have no wish to transfer national micro-prudential supervisory powers to an EU body, since the responsibility for bailing out financial institutions are on their hands. Mulas-Granados [109](2009) underlines that if crisis management becomes at the European level instead of the national level, there needs to be a federal source of money. Member states will be responsible for supervision, till the EU has fiscal powers which allow it to increase the required funds in order to rescue distressed banks, or till existence a system whose mandatory burden sharing between member states for fiscal support. Under this circumstance, the actual role of any EU financial body will be limited. Directorate-General Internal Market and Services, European Commission (DG Markt) has the similar idea that since member states bail out the banks, it is doubtful to cede on supervisory powers to any EU body. The Bank of England states that the capability of ensuring capital of last resort relies only on the national fiscal authority.

William Buiter expresses [110](2009) that the reason behind the ECB/Eurosystem to reject to hold neither outright purchases of private securities nor in unsecured lending to the banking sector (or to the non-financial enterprise sector directly), is that there is no 'fiscal Euro Area', and fiscal EU as well. In the sense of absence of a fiscal Europe, Buiter points out two related fiscal vacua. Namely, first one is that the absence of any single fiscal authority, facility or arrangement which could lead to recapitalise the ECB/Eurosystem, if the Eurosystem has capital losses, because they jeopardize its scope to carry out its price stability and financial stability mandates. The second one is that the absence of any single fiscal authority, facility or

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[108] European Union Committee, 1st Report (2008–09): EU legislative initiatives in response to the financial turmoil (HL 3)
[109] Edited by Roger Liddle, "After the Crisis: A new Socio-economic Settlement for the EU", 2009, Carlos Mulas-Granados, 5. Chapter, "The fourth dimension: financial supervision and economic governance", pp.85-86
[110]William Buiter, 2009, http://blogs.ft.com/maverecon/2009/03/fiscal-dimensions-of-central-banking-the-fiscal-vacuum-at-the-heart-of-the-eurosystem-and-the-fiscal-abuse-by-and-of-the-fed/#axzz1tBx6KWMW

arrangement which could lead to recapitalise cross-border financial institutions in the eurozone or non-eurozone.

Furthermore, Buiter, 2009, proposes three options to deal with the absence of ECB fiscal authority for the eurozone. He determines, namely, "in decreasing order of desirability but increasing order of likelihood": a supranational Eurozone-wide tax and borrowing authority, specifically dedicated to fiscal backing for the ECB/Eurosystem; a Eurozone-wide fund, funded by the 16 Eurozone governments; an ad-hoc, hastily cobbled together fiscal burden sharing rule for the 16 Eurozone national governments, to restore the capital adequacy of the ECB/Eurosystem.

The House of Lords, 2009 14th report, state that "the establishment of any EU body with supervisory authority and far-reaching micro-prudential supervisory roles and powers to mobilise fiscal resources in the event of crisis, or passing such powers to the European Central Bank, is difficult if not impossible whilst national governments bail-out financial institutions." (p.29)

Recently, many articles have analysed whether institutions have been developed to enhance monetary policy might also be applicable to fiscal policy.[111] These researches differentiate two major form of fiscal policy delegation, namely, fiscal council, which are fundamentally advisory bodies, and independent fiscal authorities, which would have efficient control on some fiscal tools. Moreover, fiscal councils are from day to day widespread all over the world, with an effective role among member states. Considering the "Van Rompuy report" of European Commission, 2010, which are related EU fiscal institutions asked for all member states to create independent councils to confirm their fiscal performance. Contrary to the independent fiscal authorities have been commonly proposed, almost neither of them has been established.[112]

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[111] See more: C. Wyplosz (2008), "Fiscal policy councils: unlovable or just unloved?" Manuscript, Graduate Institute for International Studies, Geneva, L. Calmfors and S. Wren-Lewis (2011), "What should fiscal councils do?" CESifo Working Paper 3382., R. Hagemann (2010), "Improving fiscal performance through fiscal councils." OECD Economics Dept. Working Paper 829., X. Debrun, D. Hauner, and M. Kumar (2009), "Independent fiscal agencies." Journal of Economic Surveys 23 (1), pp. 44-81.

[112] Costain, James and de Blas ,Beatriz, 2012, "The role of fiscal delegation in a monetary union: a survey of the political economy issues", p.9

4.3 The ECB, the UK and the Eurozone

Article 105.6 of the EC Treaty leads to cede prudential supervision of banks and other financial institutions to the ECB. In this case the ECB should be authorized as having powerfully macro-prudential supervision.

It would not be said for the ECB to become the merely supervisor of banks, whereas operate within a single institution with national market supervisors and central banks, thus comprehensive financial stability supervision cooperated with the day-to-day supervision of individual banks.[113] To fulfil the subsidiarity principle macro and micro supervision differences is crucial. According to the ECB macro and micro prudential authorities need to have the prudential information of the other ones, because an exchange of information can accomplish easily within a single institution. Although the ECB would be disposed to have an effective place in micro-prudential supervision, supervising markets of the ECB should not be assumed. It appears apparent infirmity of this choice is not acceptable for countries not in the eurozone such as UK. Furthermore, the result of transferring supervision functions to the ECB under the Article 105.6 is that the EC Treaty clearly restricts new supervisory role of the ECB to "specific tasks" related to banking supervision, excepting the insurance sector. This embodies a lower arrangement when compared to a full supervisory authority which comprises the whole financial system. [114]

Buiter, 2009, denominates that the ECB has no fiscal back-up. In that case, there is no guarantee or insurance for any private credit risk. This fault and weakness in the ECB and Eurosystem model jeopardizes that the ECB is less effective than the Bank of England concerning its capacity to engage in unconventional monetary policy.[115]

The Eurosystem has met some substantial market-to-market losses on loans. In 2008, five banks, namely, Lehman Brothers Bankhaus AG, three subsidiaries of Icelandic banks, and Indover NL, defaulted on recapitalising operations which is taken charge by the Eurosystem. Due to these defaults which are exposed to any losses are assigned by all national central banks (NCBs) in the ration of their portions in the capital of the ECB. Nonetheless, due to in the

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[113] See more: ECB executive board member Lorenzo Bini Smaghi, statement to the press (12 February 2009).
[114] Edited by Roger Liddle, "After the Crisis: A new Socio-economic Settlement for the EU", 2009, Pagoulatos, George, "Regulating financial capitalism: the EU's global responsibility" Chapter 2, p.39
[115] Buiter, 2009, Fiscal dimensions of central banking: the fiscal vacuum at the heart of the Eurosystem and the fiscal abuse by and of the Fed, http://blogs.ft.com/maverecon/2009/03/fiscal-dimensions-of-central-banking-the-fiscal-vacuum-at-the-heart-of-the-eurosystem-and-the-fiscal-abuse-by-and-of-the-fed/#ixzz1tC3GFtwj

Eurosystem the sharing any losses taken charge by its individual NCBs, there is no mechanism to recapitalise the Eurosystem as a whole. And Buiter notes that "the combination of the obvious willingness of the ECB/Eurosystem to take serious private sector credit risk through collateralised lending to banks, and its unwillingness to consider outright purchases of private securities or to engage in unsecured lending to the banking sector is difficult to rationalise."[116]

4.4 Towards a Single Supervisory Authority

According to some House of Lords' observers the establishment of a single EU supervisory authority for cross-border banks, while the largest cross-border banking groups in the EU comprise considerable amounts of total EU bank assets. This has led to take powers of supervision from national supervisors with respect to the cross-border banks and embodied a fundamental reform of the EU financial supervisory structure. Consequently, a treaty change would have been needed for the supervision of institutions remains a national competence.

Considering the collapse of the Icelandic banks, Howard Davies, [117]2009, states that the advantages of the federal approach are obvious. The single market could be supported by institutions that integrate to financial firms. Since attaining a European consensus as giving powers willingly to new central agencies, namely an EU authority, was difficult, the political difficulties appear clearly. The UK evaluates the situation that would make sense rather existence of the ECB, which might volunteer its services.

Lord Myners[118] expresses UK is against a European single supervisor, since national governments are the merely bodies in order to ensure any fiscal back-up to firms. Bank of England governor Mervyn King states banking supervision has to be national the fact that financial institutions are "global in life, but national in death", since national taxpayers have to finance for a bail-out. Moreover, Lord Myners puts forward to give new powers for EU authorities to change national supervisory decisions can weaken crisis management and fiscal accountability. With respect to the Mr de Larosiere's proposal, Lord Myners underlines that the macro-prudential body should be independent of the ECB, consequently, it represents not only eurozone but also whole EU.

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[116] Ibid.

[117] Davies ,Howard, 2009, "Europe's banks need a federal fix" http://www.ft.com/cms/s/0/a5090d94-e18f-11dd-afa0-0000779fd2ac.html#ixzz1tSjAm8py

[118] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5438787/Myners-attacks-EUs-bank-regulation-proposals.html , 29.04.2012

Guy Verhofstadt, [119]2009, underlines that the lessons from the crisis address the lack of control and supervision that permitted banks and financial institutions undue independence. A failure would have led to an increase in the risk of the disintegration of the single market. In order to consider the qualification of a single European financial authority as following the same rules around the EU, it is required to be undertaken to the disagreement of some EU countries, like UK. There is a lack of consistency in the proposed structure both the operational and the geographical division among Paris, London and Frankfurt. It will be jeopardized an effective coordination and information exchange amongst various agencies. Likewise, as macro and micro-prudential supervision are interrelated, they cannot be separated in order to be efficient supervision of cross-border financial institutions. Verhofstadt[120] supposes that "a single European Financial Services Authority would be more effective in the co-ordination of market oversight and crisis prevention than three separate bodies in three different countries and a fourth body dealing with wider systemic risks."

House of Lords, 2009, admits that the existence of a single European supervisor and a single rulebook would lead to enhance the functioning of the single market for financial services and be beneficial for cross-border banks. Considering the current supervisory arrangements, the interrelation between banking markets compared to the other financial institutions are considerable much. Regarding the benefits of further integration, if not the competence or burden-sharing arrangements on the bail-out of financial institutions are at an EU level, the establishment of a single supervisory authority cannot occur. Moreover, a significant adjustment of the EC Treaty would be demanded by the any single EU supervisory authority.

4.5 The Proposals of the De Larosière Report, the UK Government and the FSA

After the 2007-2008 financial crises hit the EU financial system, the EU Commission in the late 2008 asked a High-Level Group under the chairmanship of Jacques de Larosière to ensure advice on the future of financial regulation and supervision. The report of 25 February 2009 relied on the recommendations, the ECOFIN Council of 9 June 2009 and the European Council of 17 and 18 June 2009 came into decision on the creating of a new two-stage supervisory structure, namely, a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS).[121]

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[119]Verhofstadt, Guy, 23/09/2009, http://www.eumonitor.net/news/archive/135724, 29.09.2012
[120] Ibid.
[121] Hennessy, Alexandra, 2011, “Redesigning Financial Supervision in the European Union”, p.10

The major task of the ESRB is to focus on macro-prudential policy and advise the EU member states and the Council, but not make rules, about risks to EU financial stability.[122]

The major task of ESFS is to focus on micro-prudential supervision. The ESFS comprises three new ESAs[123] for each financial sector and national supervisors replacing the previous level three committees, i.e. the Committee of European Banking Supervisors (CEBS), the European Insurance and Occupational Pensions Supervisors (CEIOPS), and European Securities Regulators (CESR).

A two stage process of the de Larosière report to upgrade of the Level 3 Committees is related micro-prudential supervision. In the first stage they would have more active role in organising and guiding expanded colleges of supervisors and in assessing the standards of national supervisors. The second stage consists of three new authorities- banking, insurance and securities- which comprise the ESFS.[124]

Besides all of these, the UK Government and the Turner Review[125] (Lord Turner) by the Financial Services Authority have suggested alternative reforms. The three of them agree upon three common subjects, namely, institution of macro-prudential supervision, expansion of colleges of supervisors and reform of the Level 3 Committees.

[122] in detail see chapter 2
[123] De Larosiere Report, "Main tasks of the Authorities: in addition to the competences of the existing level 3 committees, the Authorities would have the following key-competences: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) adoption of binding technical decisions applicable to individual institutions, (iv) oversight and coordination of colleges of supervisors, (v) licensing and supervision of specific EU-wide institutions (e.g., Credit Rating Agencies and post-trading infrastructures), (vi) binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and (vii) strong coordinating role in crisis situations."
[124] In detail see chapter 2
[125] FSA, 2009, "The Turner Review- A regulatory response to the global banking crisis" p. 105

CHAPTER 5
THE ROLE OF THE ECB ON FINANCIAL SUPERVISION and FINANCIAL STABILITY MANAGEMENT

One of the two fundamental objectives of the ECB is to maintain price stability and general economic activity by implementing monetary function, the other is to maintain a stable and efficient financial and payments system by performing certain banking functions for the financial sector, as ensuring a final source of liquidity, involving in the payments system and regulation and supervising key sectors of the financial system. Regarding the past experiences of the ECB on the monetary policy, the basic and substantial omission is the lack of a clear mandate for the ECB to take on traditional banking functions in support of the financial market. The recent financial crisis has brought forward the requirement for the ECB to have a role in maintaining financial stability.[126]

Under the De Larosière Report, 2009, the macro-prudential supervision tasks of the ECB have been broadened. The ECB has an important role in the European Systemic Risk Board (ESRB). After all, it copes with two difficulties, namely, the requirement of tools to tackle financial stability, and relying on the European Supervisory Authorities and the national central banks and supervisors of the ECB for the provision of information. Nevertheless, the ECB has no direct role in the sphere of the micro-prudential supervision. The relationship between micro- and macro-prudential supervision is significant. Under the Maastricht Treaty which demands a consensus vote of all EU member states for assigning the ECB with financial supervision, the ECB faces two obstacles in the micro-prudential supervision. The Maastricht Treaty permits merely the assigning of banking/securities supervision rather insurance companies supervision. A sectoral supervisory approach complicates to consider the cross-sectoral nature of the financial environment.[127]

5.1 Monetary and Financial Stability

The ECB was assigned to maintain price stability under the Maastricht Treaty. Conventionally, monetary and financial stability are the main objectives of central banks. These are related to each other, namely, the real economy is affected by disruptions in the financial

[126] Folkerts-Landau, David and Garber, Peter M., 1992, “The European Central Bank: A Bank or a Monetary Policy Rule?” NBER Working Paper 4016, p.1-2
[127] Schoenmaker, Dirk, 2010, “The ECB, financial supervision, and financial stability management”, Chapter 7, in Jacob De Haan, 2010, “The European Central Bank at Ten, p.1

system, and accordingly output and inflation are affected. Similarly, financial stability is affected by monetary imbalances.

Folkerts-Landau and Garber [128](1992) put forward that a narrow concept central banking consists of monetary stability, a broad concept consists of both monetary and financial stability (like the lender of last resort (LOLR) function and supervision of financial institutions). Under the Maastricht Treaty Article 105.5 the ESCB should only contribute to the supervision and financial stability policies of the national authorities and financial supervision and stability remain competence of the member states. The fragmentation of roles has led to wide debate on the LOLR whether the LOLR function ought to give the ECB. Folkerts-Landau and Garber (1992) point out that the limited mandate for the ECB might hinder the development of the EU financial system.

Considering the recent financial crisis Schoenmaker, [129]2010, underlines that the ECB acted as LORL. Because of the banks' insolvency problems, surplus banks had doubts to lend to deficit banks in order not to lose on and exposure to sub-prime mortgages. As ensuring short-term funds to deficit banks and absorbing funds from surplus banks, the ECB was quite proactive. With respect to standing facilities, e.g. marginal lending facility and deposit facility, the instruments of ECB, e.g. open market operations, the ECB ensured liquidity, which is [130]"so-called general LOLR function, under which liquidity is available for all banks against collateral in a standardised way."

Masciandaro and Quintyn, [131]2011, express as considering the situation of the central bank, although formally the ECB is not applicable for ESFS, the Commission invited the European Council and its recommendations foresee a central role for the ECB in the ESRC with the President of the ECB chairing the Board and ECB staff providing the analytical and logistical support. The ESRC monitors and evaluates potential stability risks, as referring to these risks, the ESRC would be a significant block for an integrated EU supervisory structure. Moreover, [132]"notwithstanding the Commission considered appropriate that the ESRC should be established as a body without legal personality, this choice of legal base does not prevent the

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[128] Folkerts-Landau, David and Garber, Peter M., 1992, "The European Central Bank: A Bank or a Monetary Policy Rule?" NBER Working Paper 4016, pp.21-25
[129] Schoenmaker, Dirk , 2010, "The ECB, financial supervision, and financial stability management", Chapter 7, in Jacob De Haan, 2010, "The European Central Bank at Ten", pp.2-3
[130] Ibid. p.3
[131] Masciandaro, Donato and Quintyn, 2011, "Regulating The Regulators: The Changing Face of Financial Supervision Architectures Before and After The Crisis", pp.12-13 and also in "Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis", 2011, Sylvester Eijffinger, Donato Masciandaro,
[132] ibid. p.13

conferring of responsibilities on the ECB in respect of the ESRC by means of an act adopted on the basis of Article 105 (6) of the EC Treaty." Hence, the ECB has a significant role to maintain macro supervision and providing cooperation and integration between macro and micro supervision are the purpose of the proposal.

Boot, [133]2006, is in favour of giving the ECB responsibility over the LOLR function; accordingly, national central banks would have a more effective role. Boot supports his idea giving some examples, namely, more prudent use of the LOLR facility, in addition taking notice of communication between the ECB, national central banks and other supervisory agencies. National authorities could willingly share information with the ECB. Hence, self interest might smooth the information exchange. Furthermore, it can act as catalyst in future reforms of pan-European supervision. Particularly, due to having a stronger position, the ECB can lead the EU and ECOFIN to reinforce the role of the EU in supervision as increasing power of the ECB. Therefore, the division in supervision would decrease, convergence would accelerate and coordination would improve. Boot takes attention to a requirement of a catalyst for further European regulatory and supervisory integration for the financial sector and thinks that enlarging the powers of the ECB could be such catalyst.

De Grauwe, [134]2011, puts forward that Eurozone's institutions need a basic renovation. While renovating itself, the ECB has a crucial role by taking on the full responsibility of LOLR in government bonds markets of the Eurozone. If this guarantee does not exist, it cannot be mentioned the stabilisation in the government bond markets in the Eurozone.

5.2 Macro-prudential Supervision

Contrary to micro-prudential, which is responsible merely for the risks within individual institutions, macro-prudential is responsible for whole financial system stability including externalities. With the recent financial crisis, macro-prudential supervision has come up. As the situation for individual institutions seems well, financial instability might arise in the system. This situation has been expected. Hartmann, Straetmans and de Vries, [135]2001, describe return linkages during periods of stress by an extreme dependence measure. Their estimations relied on suggesting G-5 countries that immediate crashes between stock markets are much more likely than between bond markets. They underline the ignored cross-asset is crucial in order to evaluate financial system stability. As long as market crashes increase, the more banks are

[133] Boot, Arnoud W.A., 2006, "Supervisory Arrangements, LOLR and Crisis Management in a Single European Banking Market", p.15
[134] De Grauwe, Paul, 2011, "Only a more active ECB can solve the euro crisis ", p.5
[135] Hartmann, Straetmans and de Vries, 2001, "Asset Market Linkages in Crisis Periods" Working Paper No: 71

affected from that situation. Notwithstanding, Schoenmaker, 2010, argues that the current EU supervisory arrangements basically are related individual institutions' supervision, so-called micro-prudential, contrary to the macro-prudential where these institutions operate.

Masciandaro, and Quintyn, [136]2011, with respect to the lessons from the recent crisis, emphasise the importance of systemic risks management in the financial system as a whole, macro-prudential supervision.

Schoenmaker, [137]2010, argues key channels for systemic risk in the financial system. Due to linkages among financial institutions, shocks might raise and spread in financial institutions. In addition, because of the common exposures to shocks resulting from outside of the financial system, joint failures may appear. In that case, determining these channels and preventing imbalances are objective of macro-prudential supervision. Schoenmaker identifies this as a typical central bank objective, because monetary and financial stability correlated each other. Furthermore, Goodhart, Schoenmaker and Dasgupta, [138]2002, pay attention to the importance of skilled experts involving the supervisory process. Considering their results, contrary to the non-central bank supervisory institutions, central banks employ more economists and fewer lawyers in their supervisory/financial stability department. The findings of this study imply that an institutional setting with direct or indirect central bank involvement is more likely to produce a macro-approach.

5.2.1 Financial Stability

Eijffinger, [139]2004, puts forth the reasons of financial sector instability. Banks are vulnerable about their balance sheet. Long-term loans, which are partly funded through deposits, are ensured via banks. Due to lack of trust, depositors might take out their money. Illiquidity in money or capital markets may lead to a liquidity crisis. Due to an uncertainty in the solvency of a bank, there might be a shift in portfolios away from bank liabilities in favour of government securities or corporate assets. A substantial withdrawal in deposits or a shift in portfolios may force a bank to liquidate its loan portfolio on adverse terms. Therefore, as a liquidity crisis, a process begins and accordingly this causes a solvency crisis. In addition, problems arisen from one bank affect the other financial institutions as well. If the consequences end up for banks to go bankrupt, a serious recession occurs as the drop in the money supply. Eijfinger suggests that

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[136] Masciandaro, and Quintyn, 2011, P.14
[137] Schoenmaker, 2010, p.14
[138]Goodhart, Charles; Schoenmaker, Dirk and Dasgupta, Paola , 2002, "The Skill Profile of Central Bankers and Supervisors", pp.398-399
[139] Eijffinger, Sylvester C.W., 2004, "The European Central Bank and Financial Supervision", p.455

central bank with the deposit insurance and liquidity support might help to be hampered to this situation.

Schoenmaker, [140]2012, denominates that there are two tasks taken the ECB responsible in order to safeguard the European financial stability. First comes monitoring stability trends and taking preventive actions; and second, providing emergency liquidity assistance to European banks. The ECB is not capable of considering the first task.

In order to ensure an overview of the potential sources of risk and vulnerability to financial stability in the Eurozone, the ECB has published half-yearly Financial Stability Reviews (since 2004). The ECB chairs and assign to own staff for the European Systemic Risk Board (ESRB), which is responsible for safeguarding financial stability by conducting macro-prudential supervision at the European level. As aforementioned in chapter 3 the ESRB aims to hinder or mitigate ~~to~~ systemic risks to financial stability which come from developments within the financial system. Macroeconomic developments are considered, so as to prevent periods of widespread financial distress. In the event of serious stability risks, the ESRB provides early warnings and makes recommendation for remedial actions which is appropriate. Hence, the legislative framework for the ESRB does not provide macro-prudential tools for both the ESRB and the ECB. And the ESRB/ECB requires macro-prudential tools in order to take a leading role. Otherwise, the ESRB/ECB could cause a risk for financial stability. [141]

As a second task the ECB acts as a LOLR with providing liquidity where required for the interbank market. Art 18.1 of the Statute of the European System of Central Banks provides the main classical central banking tool:[142]

"In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, with lending based on adequate collateral".

All these show the needs for the ECB to take sufficient collateral. During the financial crisis, as enhancing the range of eligible collateral the ECB has provided LOLR actions to all Eurozone banks and it has replaced dysfunctional interbank market. In addition it has worked under a Eurozone monetary and financial stability mandate. Additionally, non-eurozone countries' banks with branches or subsidiaries placed in the Eurozone have joint to the ECB

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[140] Schoenmaker, Dirk, 2012, "Banking Supervision and Resolution: The European Dimension ", p.16
[141] Ibid.
[142] Schoenmaker, Dirk, 2010, "Burden sharing: From theory to practice" ,
http://www.voxeu.org/index.php?q=node/5685 at available16.05.2012

LOLR actions. After that the burden sharing which relied on the ECB capital key suggest broaden participation consisting of both eurozone and non-eurozone countries. Including all EU NCB governors the Council would be located in decision-making body. EBA banks would authorize to EU financial stability in the provision of LOLR actions. And national central banks would still apply to their NCB for LOLR actions.[143]

5.2.2 Information Challenge / Asymmetric Information

In order to maintain an effective macro-prudential function, the availability of broad information within the financial system can help for exposure and assessment of systemic risk. This means the ascription of specific tasks to the macro-prudential authority regarding to reaching and collecting such information. This kind of information might comprise macro-economic and micro-financial data, indicators and market intelligence. Under these circumstances, the ESAs, the European System of Central Banks, the Commission, the national supervisors and the national statistical authorities mandate in the name of the close cooperation with the ESRB and ensuring all the information significant for the implementation of its tasks. Furthermore, the ESRB may demand the ESAs to provide information also individual institutions which are prerequisite for a rational request. Hence, the ESRB would attain various sources of information on risks. Considering the assessment of the financial stability in the single market, in order to gather information, which based on EU-wide, the development of the proper infrastructure suggests obtaining a fundamental step. As a result of this, considerable analytical, data-related authorities and market knowledge are demanded.[144]

A major difficulty of the ESRB is an information exchange from NCBs and national supervisors to the ECB. Čihák and Decressin, [145]2007, express that financial institutions deal with 27 different prudential regimes and this lead to restrict the contestability of national markets. The financial stability is concerned about the external spillovers of domestic actions which probably emerge during large financial institutions crisis, namely, [146]"the diverse incentives of national supervisory agencies, who are accountable only to their domestic authorities; the dispersed and asymmetric information among the supervisory bodies both at the macroeconomic (e.g., regarding the optimal response to housing market booms) and the microeconomic (e.g., concerning cross-border transfers of assets by large groups as well as

[143] Ibid. Schoenmaker, 2012, pp.474-479

[144] Vítor Constâncio, Vice-President of the ECB, at the Eurofi Financial Forum 2010, "The establishment of the European Systemic Risk Board: challenges and opportunities Introductory remarks", plenary Session on "Implementing the de Larosière Agenda", Brussels, 29 September 2010 http://www.ecb.int/press/key/date/2010/html/sp100929_1.en.html

[145] Čihák, Martin and Decressin, Jörg, 2007, "The Case for a European Banking Charter", p.7

[146] Ibid. p.7

cross-border business and deposit insurance) level; and the resulting collective action problems and moral hazard in the large institutions."

If information on systemic financial institutions is rapidly scattered to the several national institutions, it would help prevention, management and resolution of crisis. Nonetheless, supervisors could not obtain the same set of information frequently. Since there is no complete overview on systemic risks among institutions for supervisory authority, regarding a consolidated or lead supervision system, information on the systemic financial institutions is scattered over the different consolidating supervisors. Furthermore, different supervisors imply different methodologies and they cause to contradictions in supervision among institutions which placed in the same single financial market. During crisis situation the dominant strategy for every single country's supervisory authority is against in order to share information with the other supervisors, despite any Memoranda of Understanding, and to benefit from its information to mitigate the loss to its country's treasury. The optimal collective solution which based on full information is not ex-post Pareto optimal. The approaches do not address to handle this problem in the EU. As a result of this a joint responsibility and accountability of national supervisors are required instead of "self-interested" behaviour driven by national accountability. Schoenmaker, [147]2010, has alike idea that suggests removing the national mandate of NCBs and replace it with a European mandate. Since the inception of EMU regarding the past experiences of monetary policy, this has been done for monetary policy. As maintenance of price stability in the Eurozone, the Maastricht Treaty provides an explicit competence to the ECB and the NCBs as well.

5.3 Micro-prudential Supervision

According to the ECB, the macro and micro-prudential authorities have to access bilateral prudential information in order to accomplish within a single institution as using this information. The ECB suggests acting in micro-prudential supervision but not about supervising markets. Nonetheless, it does not welcome the countries that are not located in Eurozone, like the UK. A further weakness on this solution of mandating supervisory functions to the ECB under the Article 105.6 is that the ECB's new supervisory role to specific tasks which is related to banking supervision, excepting the insurance sector, is restricted under the EC Treaty; "the Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit

[147]Scoenmaker, 2010, pp.17-18

institutions and other financial institutions with the exception of insurance undertakings". This leads to a poorer arrangement under a full blanket supervisory authority which comprises the whole financial system.[148]

The EC Treaty is likely to grant prudential tasks to the ECB. Article 105.6 states that "the Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings".

As a result, these two obstacles arise about a supervisory role for the ECB. Notwithstanding, many EU member states, e.g. France, Italy, Spain, Portugal, Greece and the Netherland, are in favour of central bank model for supervision, the EC Treaty demands a consensus in voting within all EU member states to assign the ECB for financial supervision. When a direct central bank involvement in financial supervision is in question, Germany and the UK do not support that idea. From the Germany's standpoint, the independence of monetary policy is essential. Due to supervisory failures, the monetary reputation should not be jeopardized with regard to having a strong monetary reputation and no direct involvement in banking supervision from the side of the Bundesbank already.[149]

The supervisory power of the banking system was hived off from the Bank of England in 1997 and granted to the Financial Services Authority (FSA), because incoming Labour government put forward that the Bank of England failed. After that as Conservatives government ponders the FSA has also failed, on 16 June 2010, the Chancellor of the Exchequer, George Osborne, announced plans to abolish the FSA and separate its responsibilities between a number of new agencies and the Bank of England.[150] In the light of this information the UK supports the separation of monetary and supervisory powers. Additionally, the UK does not support to grant supervisory powers to the ECB, since the UK is in the non-eurozone, therefore, it has no or barely influence over the ECB. Subsequently, merely the transfers of banking and securities supervision, excepting the supervision of insurance firms, are permitted under the Maastricht Treaty.[151]

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[148] Pagoulatos, George, 2009, "Regulating financial capitalism: the EU's global responsibility", chapter 2 in "After the crisis: new socio-economic settlement for the EU", edited by Roger Liddle,, p.39
[149] Schoenmaker, 2010, pp.23-24
[150] Keegan, William, 2010, "The Bank of England is back in charge. Let's hope it's concentrating", 06.05.2012, http://www.guardian.co.uk/business/2010/jun/20/william-keegan-bank-of-england-supervision
[151] Schoenmaker, 2010, pp.24-25

The ECB is responsible for primary stability when it comes to the payment system. Nevertheless, the ECB generally is not responsible directly to maintain the stability of the financial system and general principle of the individual LOLR role is granted to national central banks. Therefore, the ECB has no direct role formally.[152] Whereas, when the financial supervision and stability arrangements are concerned at the European level, the ECB is well placed to play the individual LOLR role.[153] Willem F. Duisenberg, former and first president of the ECB decelerated, as in the Vives study [154]2001, "For the markets it would be sufficient to know that there is a clearly articulated capability and willingness to act if really necessary....... The main guiding principle within the Eurosystem with reference to the provision of emergency liquidity to individual financial institutions is that the competent national central bank would be responsible for providing such assistance to those institutions operating within its jurisdiction". In the light of this explanation if a general liquidity crisis in the payment system is in question Duisenberg emphasized that it can be expected a direct involvement of the ECB.[155]

Besides, LOLR operations have risks, because LOLR support manages liquidity problems of banks, liquidity problems, and these frequently become solvency problems. The problem is that central banks' unlimited amounts of liquidity leads to their capacity to bear losses which are restricted to their capital base. A national government is a backing for own national central bank. Nonetheless, there is the question arisen that who would take on the credit risk on the LOLR operations of the ECB. [156]

Goodhart and Schoenmaker, 2009, analyse that possible ex-ante mechanisms for fiscal burden sharing in a banking crisis in Europe, since such burden sharing would merely work under the condition of the rules are in favour of ex-ante and legally binding. As an appropriate burden sharing, systemic risk in the EU financial system relies merely on capability of dealing with at the EU level. Nonetheless, with respect to politicians they are likely unwilling to cede on part of their sovereignty to spend taxpayers' money.

In addition, full access to supervisory information as mentioned above is also essential in micro-prudential supervision as important as in the macro-prudential supervision for the ECB. Pagoulatos, 2009, notes that considering the risk situation of a financial institution, information

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[152] Boot, 2006, pp.7-8
[153] Boot and Marinč, 2008, "Crisis Management and Lender of Last Resort in the European Banking Market", p.8
[154] Vives, Xavier, 2001, "Restructuring Financial Regulation in the European Monetary Union", p.64
[155] Boot, 2006, p.7
[156] Schoenmaker, 2010, pp.24-25

is not efficiently shared among various supervisors. Consequently, financial contagion appears and disruptions in a market could spread to other markets. The failure of Northern Rock in 2007 can be given as an instance, because the Bank of England was late to notice to the funding problem at Northern Rock. Hence, in order to be succeeding in LOLR, there should be an effective and closely coordination among prudential supervision. De la Dehesa, [157]2009, underlines that the lessons from the crisis show that when governments and independent institutions are responsible for the system of supervision, they were quite deficient. On the other hand, when the central banks are responsible, they are contrary to the others quite efficient in terms of soundness and stability. As a result of that, central banks should be granted to the leading role of supervising the conduct of financial markets and consumer protection, which is so-called twin-peak approach, namely, [158]"central banks supervising the health and conduct of all financial entities while independent agencies supervising the health and conduct of all financial markets and consumer protection."

Under these circumstances, if the ECB has more right to get involved more supervisory operations; the ECB could more voice for the combination of monetary policy and prudential supervision. Accordingly, the ECB will grant to supervisory information on banks as accessing directly. Nonetheless, it does not seem for the ECB to have such a direct role in micro-prudential supervision. The ESRB has a significant place in the ECB, NCBs and European Supervisory Authorities in order to promote financial stability. An effective and appropriate of the ESRB operations rely on the information exchange among the central banks and supervisory authorities.

[157] De la Dehesa, Guillermo, 2009, "Should the ESCB Be the Leading Euro Area Supervisor?" Briefing Paper for the ECON Committee of the European Parliament, 32-35
[158] Ibid. p.1

CHAPTER 6
ALTERNATIVE APPROACHES FOR SUPERVISION IN THE EUROPEAN FINANCIAL SYSTEM

The primary rationale and principle of arrangements, the differences within incentives which aimed to protect, the differences within approaches that depend on perceiving and hindering risks by the regulatory and supervisory authorities, and the problems derived from these differences during and after the integration process lead to be sought different solutions by the researchers rather than gathering the regulatory and supervisory authorities of three sectors under the same roof. These differences can lead to be made arrangements by authorities as depending on perceiving risk of dominant institutions in the economy, and be avoided to the regulatory and supervisory objectives within the rest of the other sectors. Regarding an effective price evolution that is one of the most important objectives in the capital market sector, informing public timely, efficiently and correctly cannot implement, since in a bank intensive country, authorities act as banking based. In order to inform about the financial situation of banks whose securities operate in markets, from the investors standpoint both security and debt instrument are essential. To keep the banking financial structure from risk, if integrated authority do not share information which is supposed to be given investors, as losing own identity capital market sector authority will be turn into a banking authority.

In this part, due to these differences do not need any requirement of gathering under the same roof for an effective regulating, supervising and monitoring within three sectors, some alternative approaches are discussed.

6.1 Twin Peaks Approach

Twin Peaks approach was proposed for the first time in 1995 in England by Michael Taylor, an academic and a former employee of the Bank of England, in order to restructure during the period debate of financial markets and supervision authorities. Mainly, twin peaks model, based on the differences in the purpose of supervision function between financial regulations and financial markets, aims to establish an optimal control.

Taylor, [159]2009, states that twin peaks rather than being structured around the general tripartite authorities, namely the Treasury, the FSA and the Bank of England, distinction of banking, securities and insurance, the institutional structure of regulation should consist of two

[159] Taylor, Michael W., 2009, " The Road From "Twin Peaks" – And The Way Back", p.78

regulatory institutions, namely, a Financial Stability Commission and a Consumer Protection Commission. The former would handle the maintenance of stability of the financial system as a whole, basically the prudential supervision of systemically crucial firms such as banks, insurance companies and fund managers and would require “close links” with the central bank. Prudential supervision comprises the financial soundness of the institution and a fair senior management.[160] The latter would be responsible for conduct of business, in other words, it would guarantee relationships between financial institutions and retail customers in a fair and transparent manner and it would handle the detection and prosecution of insider dealing and market manipulation.[161] Both two Commissions would deal with for fulfilling their mandate irrespective of the legal form of the firms that they regulated.

In 1996 Taylor also puts forward that a restructuring based on the certain separation among banking, insurance and securities would not be the best method considering the “blurring boundaries” arguments in financial markets. From the standpoint of the [162]House of Lords, integrated supervision was a consequence to a blurring of the boundaries among different financial operations. For instance, banks are getting more comprised in securities markets and through the securitization market. Also insurance companies have invested banking assets. Controlling institutions according to their legal status in a system means that it is likely to handle the same operation in different ways. Hence, this can cause inefficient regulatory arbitrage. Nevertheless, integrated supervision prevents this problem, as functional supervision in operations instead of institutional. What unnecessary is that communication between institutions has cost. Furthermore, regulated entities require dealing with merely one supervisory relationship.

The major justifications of twin peaks approach; 1) increasingly gaining importance of financial institutions in economy; 2) the current legal arrangement and restructuring lead to unfair competition among different financial institutions; 3) financial conglomerates require a group basis overview; 4) an ability of using effectively a few experts in legal arrangement.[163]

In practice, for the first time Netherlands and Australia have adopted the twin peaks approach. In the Netherlands the central bank (De Nederlandse Bank) is in charge of prudential

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[160] Ibid. And Jill Treanor, Regulators Back Taylor’s Twin Peaks Theory, THE INDEP., Oct. 29, 1996, available at 09.05.2012, http://www.independent.co.uk/news/business/regulators-back-taylors-twinpeaks-theory-1360780.html
[161] Treanor, 1996
[162] The House Of Lords, 2nd Report of Session 2008–09, p.29
[163] Llewellyn David T., 2001, “The Creation of A Single Financial Regulatory Agency in Estonia: The Global Context, the summit held in Turin, Challenges for the Unified Financial Supervision in the New Millennium”, pp.27-28

supervision and the market authority (Autoriteit Financiële Markten, or AFM) is responsible for conduct of business rules. In Australia the Australian Prudential Regulation Authority (APRA) is in charge of prudential supervision, the Australian Securities and Investments Commission (ASIC) manage to conduct of business supervision, and the Reserve Bank of Australia acts as the central bank, in particular acting as lender of last resort. In the Australian system three bodies are taken into account, sometimes it is described as "triple peaked."[164]

Taylor, [165]1995, expresses several advantages of twin peaks approach, namely;

"The benefits of 'Twin Peaks' are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it could encourage a regulatory process which is open, transparent and publicly accountable. As such, it is consistent with the current philosophy of 'unbundling' the functions of public sector agencies to achieve greater transparency, efficiency and clearer lines of responsibility. In all these respects, it marks an advance over the existing institutional structure."

Taylor, [166]2009, underlines with regard to the recent financial crisis, new financial markets led to an increase in the interconnectedness of financial institutions and problems in a one financial market could spread easily to the others. He notes that the central bank should lead in a crisis is beyond the dispute.

Although merely the Bank of England (BOE) has the financial resources to perform in a crisis, the tripartite structure has not succeeded for the reason that it has sought to place the BOE and the FSA on an equal footing. The Treasury ought to abandon to micro-manage the dealing with financial crises. It can be kept informed as long as the problem is not one of solvency and does not need the injection of public funds, it does not be required to be lead manager. Taylor is against the Conservatives' white paper. He evaluates their proposals which do not ensure to differentiate adequately among systemic risk regulation and the regulation of systemically

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[164] The House Of Lords, 2nd Report of Session 2008–09, "Banking Supervision and Regulation", p.34 at footnote

[165] Michael Taylor, 1995, "'Twin Peaks': A regulatory structure for the New Century, Centre For the Study of Financial Innovation" as in the report 1996,"The Colonial Group, Wallis Inquiry Submission", p.21

[166] Taylor, Michael, 2009, "Twin Peaks- Events have reinforced the argument in favour of a simplification of the tripartite regulatory arrangement", at available 08.05.2012 https://www.financialworld.co.uk/Archive/2009/2009_09sept/Features/Michael%20Taylor/17268.cfm

significant firms. As the BOE is granted with the prudential powers of all firms, they also make the similar mistakes as emerged the FSA which granting many tasks to one agency.[167]

De la Dehesa, [168]2009, is in favour of this approach. He denominates that "the "twin peaks" approach is the most efficient for the Euro Area, provided that the central bank is the "peak" that takes care of the supervisory role of the soundness, safety and stability of all financial entities leaving the other supervisory policy role of transparency and consumer protection to the government (or another agency independent from the government)." (p.3)

On the other hand, Lord Turner denominates three problems with the twin peaks supervision. 1) Repeating effort; 2) the difficulty differentiating between prudential and conduct of business supervision; 3) suggestion of comprising crucial adjustment costs in the UK.[169]

According to the House of Lords, 2nd report of session [170]2008-09, due to merging the BOE's responsibility for monetary policy with the responsibility for bank supervision, also two problems can be appeared. 1) Because of the failures in activity, the BOE's reputation would be at risk. Mistakes in prudential supervision may jeopardize its credibility in monetary policy. 2) The BOE's two tasks may lead to a conflict of interest which is between conduct of business and prudential supervision. In other words, a twin peaks approach to financial regulation manages the risk that one conflict of interest is substituted by another which is between prudential supervision and the conduct of monetary policy.

The House of Lords emphasizes that government consists of granting the BOE responsibility for micro-prudential and also macro-prudential supervision of the financial sector, additionally its monetary policy role, ceding responsibility for conduct of business supervision with the FSA. A twin peaks approach would guarantee that the BOE had the required information to deal with financial crises. In addition, the Financial Stability Committee ought to be still a Bank of England Committee, whereas ought to comprise senior FSA representation in adequate numbers. And the re-constituted FSC should locate as central institution for macro-prudential supervision with administrative responsibility for a macro-prudential policy instrument. As a result of this, the potential for conflict between conduct of business and prudential supervision also would be reduced. Nevertheless, the House of Lords claims that [171]"the case for a twin

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[167] Ibid.

[168] de la Dehesa, Guillermo, 2009, "Should The ESCB Be The Leading Euro Area Supervisor?" Briefing Paper for the ECON Committee of the European Parliament, p.3

[169] House Of Lords, 2nd Report of Session 2008–09, p.34

[170] Ibid. pp.34-35

[171] Ibid. p.35

peaks system of regulation is by no means as clear-cut as that for locating an executive FSC with responsibility for macro-prudential supervision within the Bank. The Government would need to consider whether giving the Bank responsibility for micro-prudential supervision would create countervailing organizational problems concerning the governance of the Bank and the role of the FSA."

6.2 Four Peaks Approach

A four peaks approach deals with additionally two aims of the financial regulation denominated in twin peaks approach in a tripartite structure. Since the recent crisis also shows the lack of organisation in financial supervisory responsibilities, e.g. central banks, EU ministers and treasury authorities. As a result of this, Di Giorgia and Di Noia, [172]2001, proposes using a four peaks approach that parallel separates responsibilities along with objectives.

Regulation and supervision ought to be coordinated as being parallel to objective. Divided institutions should be responsible for macroeconomic and microeconomic stability, investor protection and competition for all intermediaries including insurers. Every single objective should comprise a federal structure with a similar structure for the European System of Central Banks (ESCB).

[172] Di Giorgio, Giorgio and Di Noia, Carmine, 2001, " Financial Regulation and Supervision in the Euro Area: A Four-Peak Proposal"

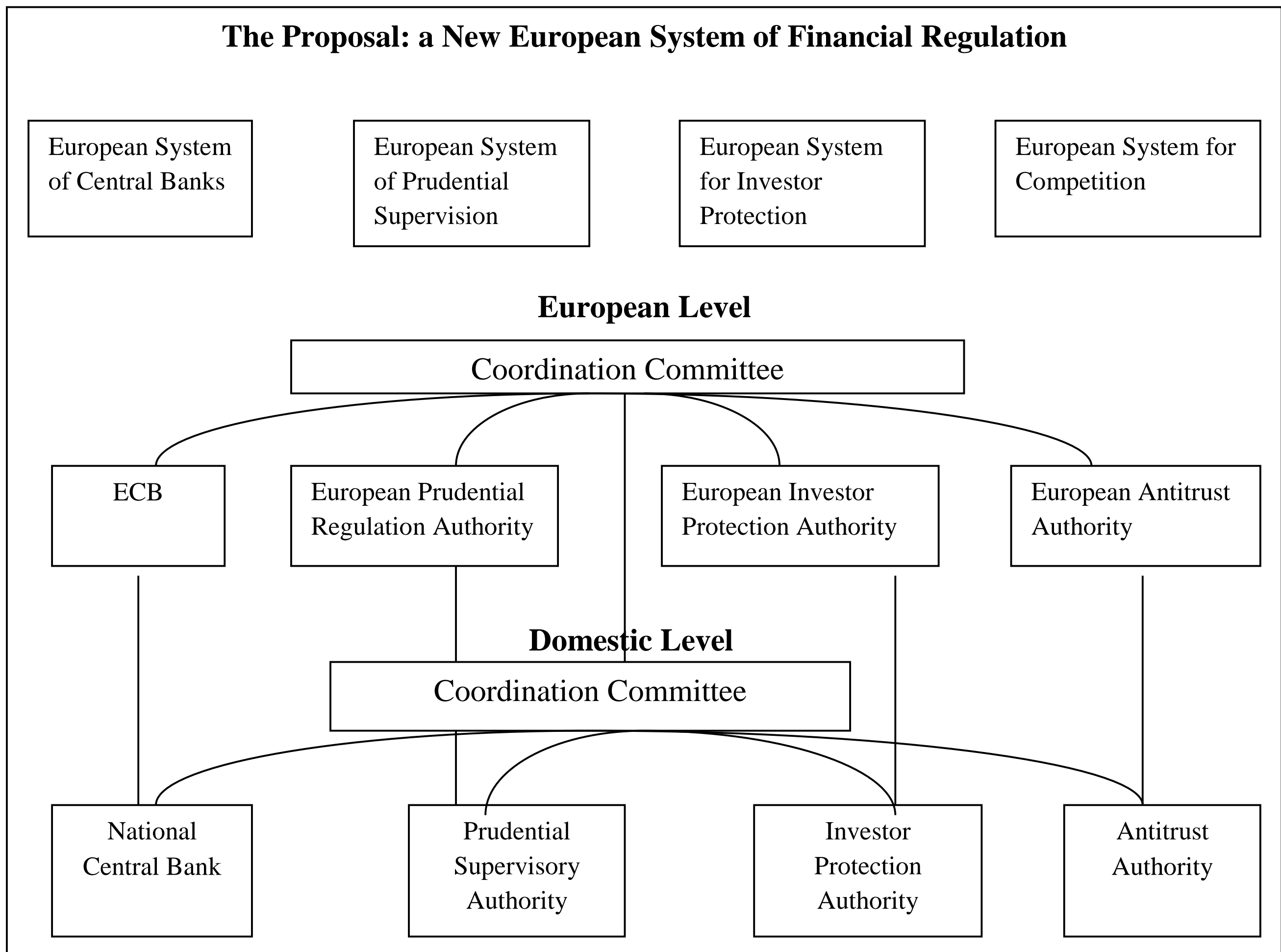

Figure 6.1 The Proposal: a New European System of Financial Regulation
[173]**Source:** Di Giorgio, Giorgio and Di Noia, Carmine, 2001

The ESCB should be in charge of macro stability issues and lending of last resort within the whole EU, both eurozone and non-eurozone, thus to prevent unclear meetings with the UK.

Next, using the expertise of the ECB, national central banks, CEBS and CEIOPS, which are renamed under the De Larosiere Report as ESMA and EIOPA, a European System of Prudential Supervisors, should be created. In the system a central entity should be represented that it is responsible for the prudential regulation of all intermediaries whether in banking, securities or insurance[174] and of the coordination of the national authorities, possibly created by objective in each country. The competence of the national prudential supervision authorities ought to comprise all supervision rather than regulation.

As a third peak, a European System for Investor Protection should be established. It should supervise all regulation of conduct of business rules of all intermediaries, comprising insurance

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[173] And at available www.voxeu.org/index.php?q=node/2462
[174] Such as; authorizations; professional registers; supervision in the area of information, regulations and inspections of intermediaries and conglomerates; other matters regarding stability; crises management

and pension funds, transparency of all financial products- from banking deposit to insurance contracts- and issuers and markets. Furthermore, some supervision ought to be applied in the event of multinational intermediaries or issuers. Also it should supervise macro transparency in financial markets.[175]

The fourth peak which has already existed with a central entity, DG Competition, should ensure fair competition and prevent abuses of dominant position and limit dangerous concentrations in banking, securities and insurance sector. The authority's a non-binding idea to maintain stability may be considered in precise examples.

Di Noia, [176]2008, in his article states that not only at the European but also at the national levels, cooperation suggests also required horizontally, excluding this vertical form of coordination. This coordination and ultimate decision of debates can be ensured by special Commissions for the Supervision of Financial System created at the EU Council Level and at national treasuries.

Di Giorgio and Di Noia, [177]2001, however, admit that their proposal needs a considerable coordination between the different authorities because of being very challenging. Another essential difficulty is the institutional and political resistance of the existing national authorities, and they are unwilling to grant their powers. As a result of these, as a second best solution, the establishment of a single regulator, by combining the financial supervision authority and the market transparency institution into a single one, no matter how less satisfy from a theoretical point of view. In particular, considering in the medium term such a three-peak approach can be good and more practical solution to apply. In that case, the single European Central Agency for financial market regulation suggest to work together with the ECB for the macroeconomic stability aims. Moreover, it would arrange and manage the work of the several national institutions, where different countries can be either specialized by objective or in charge of market transparency and stability such as the FSA in the UK.

6.3 Ex-Ante Burden Sharing

In order to permit cross-border recapitalisation, if pan-European burden sharing enables, it would have to rely on ex ante rules. Goodhart and Schoenmaker, 2006, in their research deal

[175] Di Giorgio, Giorgio and Di Noia, Carmine, 2001 and Di Noia, Carmine, 2008, "A proposal on financial regulation in Europe for the next European Council"
[176]Di Noia, 2008, www.voxeu.org/index.php?q=node/2462
[177] Di Giorgio and Di Noia, 2001, P.23

with two major mechanisms for ex ante agreement on burden sharing at the European level, namely; general fund and specific sharing.

In general fund mechanism, in order to bear the burden of a recapitalisation, a European fund would be financed ex post by the seigniorage of the ECB and other central banks. The general fund mechanism implies as an instance of general burden sharing by countries. Furthermore, the costs are mitigated over time. Nevertheless, Goodhart and Schoenmaker underline three main problems within this mechanism. 1) Due to this mechanism, there will be international transfers among countries. For instance, a country might have to support its share to the recapitalisation of a problem bank that does not manage its jurisdiction. Countries are unwilling to adopt for schemes with built-in transfers, if there is not strong political commitment for solidarity, such as, development aid, European regional funds. 2) As a result of general burden sharing, adverse selection and moral hazard problems appear. Countries which have weak banking systems benefit over countries which have strong banking systems. Hence, countries which have strong banking systems are unwilling to adopt, namely, adverse selection. Since the relationship between for a recapitalisation and responsibility for ex ante supervision is diminished, supervisory authorities might seem less of inducement to ensure a sufficient level of supervisory attempt, namely, moral hazard. 3) Burden sharing arrangements cause to the free-rider problem. With respect to the stability of the European financial system is a public good, thus countries which do not enrol to burden sharing still profit from this situation.

In the specific sharing of the burden mechanism, the burden is shared merely by countries where the failing bank is present according to some key reflecting the different countries of the business of the failing bank. As an advantage of this mechanism, almost never international transfers exist. Nonetheless, the specific sharing causes also a free-rider problem, like in the general fund.

Besides, there are some worries about both mechanisms. 1) A worry is about foreign banks in small countries. 2) Considering burden sharing for international banks whose business mostly related outside Europe, it could be hard to arrange. Besides all of these, in order to generate binding ex ante burden sharing arrangements, a legal basis is required. Goodhart and Schoenmark state that since Memoranda of Understanding (MoUs), which are available generally to use for national supervisors, are not enforceable, they will not be adequate. However, a legal basis can be quickly ensured within the EU, because of the existence of the legal arguments and the institutional framework to bargain and enforce such arguments. Finally,

any such international, ex ante, burden sharing mechanism would rely on a complex and unmanageable decision making process. At least fiscal and supervisory arrangements are correlated each other and should work together.[178]

6.4 Other Approaches

The debates related to the integration of supervisory authorities and requirement of effective implementation within the process focus on results which are expected from integration. Hence, the requirement for evaluating of different alternatives comes to light. In case of being serious doubts especially about a successive integration process, although integration is even a desirable solution in the long term, some reconstructions could be implemented by the analysts at least as an interim solution considering also specific characters of related countries. In respect to this, the suitable regulatory structure emerges to differ from country to country. Therefore a main issue should be whether this type of financial regulatory structure is appropriate to the individual situations of a particular country.[179]

The first and the most promoted option is to remain the existing regulatory structure in place, whereas to cover it with a newly established board. The board can be constructed by the heads of the different regulatory institutions or it can be enlarged to comprise third parties, as representatives of the ministry of finance and the central bank. The board may ensure either a discussion for accelerating communication and information sharing among the institutions, or it can be assigned to executive decision-making, consisting of the policy setting. A significant feature of this body can be organize regulatory efforts, such as by coordinating joint inspection visits. Such an alternative to regulatory unification, a possible model is established in South Africa.[180]

Under an oversight board, a more formalized basis for arranging the supervision of financial conglomerates than a lead regulator arrangement could be obtained. Nevertheless, problems are not abolished, and the problems could arise from differences in regulations, rulebooks and enforcement powers. It might lead to get an opportunity for the regulatory institutions in order to obtain some inference as working together for a purpose to make possible their unification in the future. Due to remaining the existing regulatory system, it does not need main new legislation or a far-reaching change management process. Nonetheless, the simple aim of this approach might be also its supreme weaknesses. The oversight board's chairman can have a

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[178] Ibid.

[179] Abrams, Richard K., Taylor, Michael W., 2000, "Issues in the Unification of Financial Sector Supervision", IMF Working Paper, WP/00/213, p.3

[180] Ibid. pp.3-4

significant role, thus would create competition amongst the heads of the regulatory institutions. In addition, if the board is expanded to permit for an outside leader, political debates and power operations can simply appear. Moreover, in case of being possible of important economies of scale, this approach is not suitable. In the light of these circumstances the oversight board model is most suitable for comparatively large financial markets where conglomerates are an essential component of the financial system, whereas the overall market size is adequate to encourage some specialist regulators.[181]

Another proposal of an alternative solution to accomplish economies of scale without unification would remain to the institutions as separate legal entities, whereas under the condition of placing them in the same building with shared infrastructure and support services. An oversight board structure can be comprised to grant complete direction to the separate institutions and to guarantee that they arrange their efforts. On the other hand, a centralized management structure can be enhanced as an administrative instead legislative issue. Due to the physical closeness of regulatory staff, superior informal information sharing and coordination might be promoted as well.

Notwithstanding finding a proper building to gather all of the regulatory institutions may take time, such an arrangement can be comparatively rapid and easy to employ. Alternatively, it represents several advantages of unification without some of the associated costs. Furthermore, it prevents the risk that new legislation may cause a suboptimal result. The main disadvantage of this approach is that the absence of a dominant central management authority may cause competitions and unresolved tensions among the senior staff of the different institutions. This agreement might not be properly created to handle financial conglomerates. The different institutions suggest keeping operating under different statues, rule books and applying different powers. Therefore, it may be hard to accomplish to coherent treatment of varied financial groups.[182]

The best appropriate approach for countries with small financial sectors where financial conglomerates are not an important presence would be thus this. In such circumstances, this approach leads to an achievement of the economies of scale without managing the risks associated with more essential change. Nonetheless, in these circumstances in which banking supervision is maintained by the central bank, this might not be possible alternative, as taking

[181] Ibid. pp.20-21
[182] Ibid.pp.22-23

the banking supervision function from the central bank would be possible to cause the difficulties of staff preservation and a reduction of regulatory capacity. [183]

Another approach puts forward that if the regulatory authorities were to share the central bank's facilities, the above mentioned problem could be prevented. One alternative would lead to grant to the central bank for supervision of all financial intermediaries. Nevertheless, another approach would be created by the supervisory authority as a separate legal entity; however one shares the support infrastructure of the central bank, such as in Finland experience. Taylor and Fleming, [184]1999, similarly note that there is another way of trying to accomplish essential economies of scale rather than integrated supervision. In the Finnish case as the FSA shares the support infrastructure of the central bank, the Finnish case might propose an alternative model short of the fully integrated model adopted in Denmark, Norway and Sweden. By using of the administrative services, as data collection, all administrative support and human resource functions provided from the Bank of Finalsn, the Finnish FSA has been able to accomplish essential scale economies as well. In addition, important professional synergy benefits associate to the close supervisory cooperation with the central bank with regard the payment system and electronic money.

The Finnish approach depends on two major appeals. [185]"First, it allows for the realization of significant economies of scale, comparable- or perhaps greater- than those that might be expected from a stand-alone unified supervisory agency. Second, this arrangement may actually prove superior to a stand-alone agency for crisis management. If the supervisory agency shares the same premises and IT systems as the central bank, and its staff are also employees of the central bank (as is the case in Finland), then information flows and coordinated action in the event of a crisis should be facilitated." That is why Finland adopted this approach.

Nevertheless, moral hazard is the basic disadvantage of this approach. As a serious doubt about the unification within the central bank is that it could develop the comprehend central bank ensure of support to all financial institutions, nonbanks as well. Therefore, if the central bank comprises a unified supervisory authority, the risk in this situation is that the public and industry perception will be that the two institutions are indeed the same. In addition, they promote that all supervised institutions will benefit from the central bank support.[186]

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[183] Ibid.
[184] Taylor, Michael and Fleming, Alex, 1999, "Integrated Financial Supervision: Lessons of Northern European Experience", p.11
[185] Ibid. P.24
[186] Ibid. P.29

In the light of the information above, whether being in favour of integration or not, the researchers have the idea in common that the integration needs to assess for each country within its dynamics and to implement to the process well-qualified. Therewithal, for countries preferred the reconstruction, the existence of a necessity in impetus appears. In financial sector, in order to maintain stability, protect consumer rights and prevent unfair competition- which are the main objectives of financial regulation- an obvious requirement, which is supposed to be attained, emerges in the first place.

Another important issue is no matter which method of reconstruction adopts, changing only the reconstruction will not be an answer to accomplish the aim. The efficiency problem in financial regulations appears beyond the reconstruction of authorities. Efficiency can be obtained simply through the formation of implementation in existing regulations, close coordination within sectors and an efficient supervision. This means that is totally independent from reconstruction with related authority. Rather it can be put forward that in order to provide efficiency of financial regulations, expert authorities are more significant.

CONCLUSION

Financial supervision in the European system requires developing increasingly with growing market integration. A coordinated approach is essential to manage systemic issues that will no longer be limited to national borders in order to monitor financial institutions with operations in a range of European countries.

With regarding the structure of financial supervision at European level, there is almost an agreement upon the requirement of a more horizontal approach which relies on the objectives of supervision. It is adjusted to the conglomeration in the financial system and mitigates to control and manage shortcomings in the current supervisory structure. Considering systemic issues, there is not such a suggestion as granting merely responsibilities to the central banks, whereas the role of the ESCB can profit from more public clarification. Furthermore, central banks, supervisors and finance ministries require cooperating to draft principles governing bailouts of European-wide groups that completely fall to the country of consolidated supervision. While the LOLR role supposes the support of a finance ministry, which might not be arranged to bail out creditors in other member states, burden sharing among EU members is presently the only way forward.

From the supervisory standpoint, more coordination is required amongst the various sectoral supervisory authorities, since this is probably most needed in order to continue the reconstruction in European finance.

The existence of the ESRB can be beneficial for evaluating macro-prudential systemic risks, which are deriving from financial institutions and markets. However, it has to be ensured by structures that support the likelihood of macro-prudential risk warnings from any EU-wide body managing to alleviation of risk by national supervisory bodies. The actual effectiveness depends on the level of political support for the ESRB which is more difficult to predict.

The existence of colleges of supervisors might be useful regarding the cooperation among supervisors. It can be supported because of enhancing colleges to overall cross-border EU banks and provisions for meetings of core supervisors which are essential to enlarge efficiency of supervisory cooperation.

The EC Treaty and fiscal issues lead to essential problems for the proposal to improve Level 3 Committees into authorities. Nevertheless, while the de Larosière report denominated

weaknesses and failures of micro-prudential supervision of financial system in the single market, it has more power than Level 3 Committees. It is required to settle disputes within the limitations of the EC Treaty and the location of fiscal authority with the requirement to develop to micro-prudential supervision of the single market.

Regarding the authorities, the significant issue is not being whether as three or two separate institutions or one integrated institution. Rather, the essential point is to create close working procedures in overall proposals, yet still have an understanding of features of the three areas of banking, securities and insurance.

As long as the establishment of colleges of supervisors and the advanced role of the ESAs ensure the cooperation and information sharing between national supervisors, it might be sense, because they suggest beneficial process to greater coordination of supervision within the EU that do not need Treaty amendment or provide difficulties over the location of supervisory authority.

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I declare that this thesis and work presented in it are my own and have been generated by me as the result of my own original research.

None of the parts of this thesis has previously been submitted for a degree or any other qualification at this university or any other institution.

The written document matches completely to the CD version.

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