EMU and banking supervision

The introduction of the single currency has strengthened the internationalisation of banking activities in the euro area. The amalgamation of the infrastructures for large-value payments and interbank markets, and the increasing integration of the capital markets have already produced more and new kinds of links between banks. While the bulk of risks in traditional banking activities still arise in domestic markets, the changes fostered by the introduction of the euro leave banks increasingly exposed to shocks originating outside national boundaries. The institutional framework for banking supervision largely relies on national arrangements, which still display a wide range of solutions. At the same time, it requires extensive co-operation between national banking supervisors, and between national supervisors and the Eurosystem, in order to ensure an adequate exchange of information and a smooth management of crises, whenever they entail cross-border effects. While, in principle, the institutional framework (i.e. the Treaty establishing the European Community and the relevant EU Directives) is adequate, operational arrangements for supervisory co-operation need to be enhanced in order to ensure that supervision is carried out effectively in an increasingly integrated euro area banking market. Some steps in this direction have already been taken, and the process has to continue. The Banking Supervision Committee of the European System of Central Banks (ESCB) has been established in order both to assist the Eurosystem in its role of contributing to the smooth conduct of national policies in the field of prudential supervision and financial stability and to develop co-operation between supervisory authorities.

1 Internationalisation of banking and prudential supervision

The globalisation of financial activity has increasingly called for updating and enhancing safeguards for financial stability. Prudential supervision – i.e. the requirements for the sound and prudent conduct of banking and financial activity, controls to monitor compliance and instruments for corrective action – has already undergone substantial changes since the mid-1980s. The growth in cross-border activities has necessitated increased co-operation between supervisory authorities and joint efforts to design a common set of principles and requirements for preventing financial crises. The Basel Committee on Banking Supervision has been the main body fostering co-operation between banking supervisors and has contributed to the design of a general framework which has been applied to G10 countries and which has gradually been expanded worldwide. Traditional tools limiting the scope of permissible activities, a geographical expansion of business and price-setting by banks have gradually been dismantled. Capital requirements, obliging banks to maintain an adequate level of own funds relative to the risks undertaken, are now one of the cornerstones of prudential regulation. The focus of banking supervision is increasingly on the procedures and policies banks themselves put in place to measure, monitor and control risks. The international expansion of banking business, through increasingly complex networks of bank and non-bank subsidiaries, has necessitated extensive reliance on consolidated supervision. The ultimate responsibility for supervising international banking organisations lies with the home authority of the parent organisation, but extensive co-operation arrangements for effectively exchanging information and co-ordinating corrective measures play a crucial role.

Within the EU, regulatory harmonisation and supervisory co-operation have been promoted to a far greater extent with the creation of the Single Market for banking and financial services. Banks and financial institutions have complete freedom to provide services in any Member State, through either branches or direct supply, while being supervised by their home-country authority. Banks located in the 11 Member States participating in Economic and Monetary Union (EMU) may now also have recourse to a unified framework for accessing central bank liquidity and a fully harmonised large-value payment systems infrastructure. At the same time, cross-border activities within the euro area are no longer affected by exchange rate risk. Insofar as these developments boost the integration of banking activity, co-operation between competent supervisory authorities is becoming more and more important, both for preventing crises and for limiting their effects, should they occur.

2 Banking developments in the single currency environment

There are many different ways in which banks' operations may become more sensitive to developments occurring outside domestic borders. Changes in interbank activities stimulated by the single currency and the single monetary policy have altered the patterns of exposures between banks, potentially affecting the scope for cross-border contagion. In addition, changes in the relevance of other cross-border activities, even in the retail business, may have affected the degree to which banks are exposed to risks originating from foreign counterparts and markets. Finally, the restructuring in the banking and financial services industry is leading to the emergence of large and complex banking groups, each maintaining a strong national base, but becoming increasingly involved in area-wide activities, especially in capital market and wholesale banking business.

Restructuring of interbank activities

Banks are particularly exposed to one another in the unsecured interbank money market, consisting mostly of financial contracts with maturities of less than one year. The share of unsecured transactions, the share of cross-border transactions and the degree of concentration of the interbank market are very important factors with regard to the potential danger of contagion. If there are only few market participants and if the concentration of the unsecured interbank liabilities is high, the likelihood of a failure having stronger repercussions on the viability of other institutions is higher. In this sense, the larger market and increasing cross-border transactions might have a positive impact on financial stability. Furthermore, wider and deeper money markets can absorb liquidity shortages more easily than before, as banks can borrow from foreign institutions more readily. At the same time, should some credit institutions nonetheless find themselves in a situation of distress, the likelihood of cross-border contagion in other euro area countries is probably greater.

Interbank markets consist mainly of unsecured contracts

The share of unsecured money market transactions appears to be roughly 70% of the total interbank market in euro (disregarding foreign currency swaps). Unsecured transactions seem to dominate overnight trade, while repurchase agreement (repo) transactions are, in relative terms, more common at longer maturities, as they offer greater security. As described in detail in a previous article (entitled "The euro area one year after the introduction of the euro" in the January 2000 issue of the ECB Monthly Bulletin), the introduction of the single monetary policy framework has significantly fostered the integration of the euro area money market. Moreover, the integration of the large-value real-time gross settlement systems within the TARGET system has contributed to increasing cross-border trade. In particular, the unsecured market in euro has already become highly integrated and liquid.

Share of cross-border interbank transactions increased

The share of cross-border transactions has substantially increased in both unsecured and repo interbank markets, currently accounting

Table 1

TARGET payment flows

	1999 Q1	1999 Q2	1999 Q3	1999 Q4
All TARGET payments				
– Daily average total value (EUR billions)	964	906	884	947
– Daily average total volume (thousands)	155	158	163	176
– Average daily payment size (EUR millions)	6.2	5.7	5.4	5.4
Cross-border TARGET payments				
– Daily average total value (EUR billions)	349	351	354	386
– Daily average total volume (thousands)	25	28	30	32
– Average daily payment size (EUR millions)	14.1	12.5	11.8	12.1
Domestic TARGET payments				
– Daily average total value (EUR billions)	615	554	530	562
– Daily average total volume (thousands)	130	130	133	144
– Average daily payment size (EUR millions)	4.7	4.3	4.0	3.9

Source: ECB.

for more than 50% of overall activity in both markets. This trend has been reflected in the rising share of cross-border transactions being processed in the settlement systems for large-value payments (see also the article entitled "TARGET and payments in euro" in the November 1999 issue of the ECB Monthly Bulletin). The share of cross-border payments in total TARGET payments, in terms of value, rose from around 36% in the first quarter to 41% in the fourth quarter of 1999 (see Table 1). The vast majority of all cross-border TARGET payments involve interbank trading (more than 95% in terms of value). The total daily average value of close to €400 billion indicates that the amounts exchanged are of a substantial magnitude. The other major payment systems operating in the euro area, Euro 1 (EBA) and Euro Access Frankfurt (EAF), have a combined daily value of transactions of approximately €300 billion, consisting mostly of cross-border interbank payments.

The changing patterns of trading in the euro area interbank markets are producing changes in the geographical breakdown of the corresponding items on banks' balance sheets, as approximated by the developments in the sector of euro area Monetary Financial Institutions other than central banks (OMFIs) (see Table 2 also for a precise definition). Cross-border activity involving non-euro area counterparties still exceeds activity involving euro area ones. However, the difference has almost disappeared in the case of interbank assets, and the share of the business within the euro area has increased in terms of both assets and liabilities. The growing relevance of cross-border exposures within the euro area is more clearly reflected in fixed income securities and money market paper, while the composition of loans has changed less markedly. Within the former classes of assets, the change has been larger at the short end of the maturity spectrum. For instance, the share of securities with maturities of less than one year issued by non-domestic euro area banks rose from 47% of total interbank assets at the end of 1997 to around 60% at the end of 1999.

Concentration of the interbank market

The aggregated data may hide some important developments at the country level or, perhaps more importantly, at the level of individual banks. Average figures are heavily influenced by the behaviour of small and medium-sized banks, which have benefited from the convergence in prices and the increased liquidity of the area-wide market, while keeping their interbank activity confined to national markets. The asset and liability structure of the largest banks, which traditionally have a greater level of involvement in the wholesale business, is more likely to be extensively affected. These

Table 2

Composition of the assets and liabilities of the euro area Monetary Financial Institutions other than central banks (OMFIs) vis-à-vis other OMFIs [1)]

	December 1997	December 1998	December 1999
Total inter-OMFI claims (loans, securities and money market paper) (EUR billions)	4,673	4,964	5,366
of which domestic business (%)	63.2	64.5	64.5
of which business with other euro area countries (%)	14.7	16.3	17.6
of which business with the rest of the world (%)	22.1	19.2	17.8
Breakdown of the euro area business			
Loans (EUR billions)	2,906	3,182	3,447
of which business with other euro area countries (%)	20.2	21.3	21.9
Fixed income securities [2)] (EUR billions)	636	721	832
of which business with other euro area countries (%)	13.0	15.3	19.6
Money market paper (EUR billions)	100	107	130
of which business with other euro area countries (%)	17.6	19.0	21.3
Total inter-OMFI deposits (EUR billions)	4,098	4,451	4,884
of which domestic business (%)	58.9	58.7	57.8
of which business with other euro area countries (%)	14.5	15.7	16.0
of which business with the rest of the world (%)	26.6	25.6	26.2

Source: ECB.

1) *OMFIs (Monetary Financial Institutions other than central banks) comprise resident credit institutions, as defined in Community law, and other resident financial institutions, the business of which is to receive deposits and/or close substitutes for deposits from entities other than MFIs, and, for their own account (at least in economic terms), to grant credits and/or make investments in securities. The data refer to the business carried out by the institutions located in euro area countries. As far as the business with the rest of the world is concerned, institutions similar in type to OMFIs are considered.*

2) *Securities other than shares.*

institutions are more inclined to expand the scope of their wholesale business to the euro area as a whole and to strengthen their positions in cross-border interbank activities. TARGET statistics show that daily cross-border interbank transfers are, on average, significantly larger than domestic ones. At the same time, the number of transactions is much smaller (see Table 1). This evidence points to the possible emergence of a "tiered" interbank market structure, which would resemble the structure existing in many domestic systems prior to the introduction of the euro (or currently existing in the United States).

Further evidence of the significant role played by large institutions is provided by the data on interbank market concentration. The largest banks have a noteworthy share of total euro area interbank assets and liabilities, and a slight increase was observed during the

Table 3

Concentration of the interbank assets and liabilities in the euro area [1)]

	December 1997		December 1998		June 1999	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Market share of the 5 largest institutions (%)	11.2	14.2	11.1	14.7	13.3	15.7
Market share of the 10 largest institutions (%)	19.9	24.0	19.4	24.6	22.3	25.6
Market share of the 20 largest institutions (%)	31.6	37.5	31.4	37.8	34.8	39.4

Sources: IBCA Bankscope (individual bank data) and ECB (aggregated data).

1) *Market shares are calculated as the ratio of interbank activity of the largest banks, from IBCA individual balance sheet data, to the overall amount of interbank business available from OMFI statistics.*

first half of 1999 (see Table 3). No data are available on the concentration of cross-border interbank activities, which is likely to be considerably higher. In any event, the further extension of the market has led to a far less concentrated interbank market, for the time being, by comparison with the national currency-based markets prior to the introduction of the euro. For example, at the end of 1998 the share of the five largest banks in the most dispersed banking systems, those of France, Germany and Italy, was around 30% of total interbank activity, while in the euro area as a whole the same ratio was around 15%.

Cross-border banking within the euro area

More generally, domestic risks still continue to be very important for banks in the euro area and, for many banks, they represent the only relevant potential source of fragility. As yet, the balance sheet structure of euro area OMFIs has not, on average, undergone any major changes. While retail banking business has largely remained domestically based, the increase in cross-border activities, especially in capital market-related businesses, is affecting the balance of risks faced by the credit institutions. On the one hand, it might

Table 4

Certain balance sheet items of the euro area OMFIs

	EUR billions			As a proportion of the balance sheet total (%)		
	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 1997	Dec. 1998	Dec. 1999
Total loans	9,758	10,350	11,070	73.0	72.6	71.2
Of which:						
Loans to households [1) 2)]	2,336	2,516	2,751	17.5	17.7	17.7
Loans to non-financial corporations [1)]	2,135	2,287	2,417	16.0	16.1	15.5
Loans to general governments	885	892	886	6.6	6.3	5.7
Loans to OMFIs	3,879	4,071	4,311	29.0	28.5	27.7
Other claims on OMFIs (securities and money market paper)	794	893	1,056	5.9	6.3	6.8
Fixed income securities [3)] issued by general government	1,139	1,192	1,222	8.5	8.4	7.9
Fixed income securities [3)] issued by the non-bank private sector	280	307	377	2.1	2.2	2.4
Equity holdings	380	479	601	2.8	3.4	3.9
Other assets	1,014	1,021	1,221	7.7	7.2	7.9
Total assets	13,365	14,243	15,546	100.0	100.0	100.0
Total deposits	9,147	9,780	10,510	68.4	68.7	67.6
Of which:						
Deposits from the non-bank private sector	4,778	5,047	5,328	35.7	35.4	34.3
Deposits from general government	272	283	297	2.0	2.0	1.9
Inter-OMFI deposits	4,098	4,451	4,884	30.7	31.3	31.4
Fixed income securities [3)] held by OMFIs	874	989	1,214	6.5	6.9	7.8
Fixed income securities [3)] held by non-OMFIs	1,190	1,288	1,402	8.9	9.0	9.0
Capital and reserves	687	742	833	5.1	5.2	5.4
Other liabilities	1,466	1,443	1,588	11.0	10.1	10.2
Total liabilities	13,365	14,243	15,546	100.0	100.0	100.0

Source: ECB.
1) Data include only loans to euro area residents.
2) Including loans to non-profit institutions serving households.
3) Securities other than shares.

have a favourable impact upon the overall risk profile of these banks, provided that their operations become more diversified. Moreover, the fact that exchange rate movements can no longer occur within the euro area is a factor which contributes to the overall stability of the European financial markets. On the other hand, banks are increasingly exposed to risks arising outside the boundaries of domestic markets, thereby increasing the need to enhance supervisory co-operation.

The bulk of loans and deposits of euro area banks are still domestic

The total assets of euro area banks (as approximated by the assets of the OMFI sector) have grown quite significantly over the past two years. However, the shares of the core asset and liability items seem to have remained stable since the end of 1997 (see Table 4). The most significant individual item, loans to the non-bank private sector, has remained slightly below 40% of total assets, with around half consisting of loans to households. The security holdings, for the most part, are clearly fixed income securities. The share of equities is only 4% of total assets. Deposits from the non-financial sectors represent the most significant liability item, with a share of approximately 35%.

The bulk of the loans and deposits of euro area banks vis-à-vis the non-bank private sector are still domestic (see Table 5). Cross-border activity is more significant in terms of fixed income securities than loans, as these instruments can be more easily traded internationally. Retail markets in the euro area still display a significant degree of

Table 5

Domestic and cross-border on-balance-sheet activities of OMFIs within the euro area

	Proportion of respective (%) balance sheet items [1]			Growth rates [2] (%)	
	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 1997-Dec. 1998	Dec. 1998-Dec. 1999
Total loans [3]					
of which domestic business	79.2	79.8	79.8	7.5	7.9
of which business with other euro area countries	7.4	8.1	8.7	17.1	13.3
Loans to the non-bank private sector					
of which domestic business	92.2	92.1	91.2	8.6	9.2
of which business with other euro area countries	2.1	2.5	2,8	27.2	23.5
Total holdings of government fixed income securities [4]					
of which domestic business	77.0	72.6	66.7	-1.0	-5.8
of which business with other euro area countries	15.4	19.9	25.9	35.0	38.1
Total holdings of non-bank private fixed income securities [4]					
of which domestic business	46.6	45.3	39.5	6.7	8.0
of which business with other euro area countries	20.3	16.1	19.1	-4.5	22.9
Total deposits					
of which domestic business	75.4	74.4	72.8	5.5	6.1
of which business with other euro area countries	9.6	10.2	10.3	13.9	7.9
Deposits from the non-bank private sector					
of which domestic business	88.7	87.8	86.5	4.3	4.0
of which business with other euro area countries	5.7	5.8	5.6	6.0	-2.6

Source: ECB.
1) *Percentages do not add up to 100 because the items vis-à-vis the rest of the world are not shown in the table.*
2) *Growth rates are calculated on the basis of monthly flows, adjusted for reclassifications, other re-evaluations and exchange rate changes.*
3) *Including loans to other Monetary Financial Institutions and general government.*
4) *Securities other than shares.*

segmentation into national or even narrower regional markets, especially when compared with wholesale activities. The effects of the Single Market and the euro on retail activities are likely to take longest to materialise (see the article entitled "Banking in the euro area: structural features and trends" in the April 1999 issue of the ECB Monthly Bulletin). Nevertheless, the growth rates of cross-border business within the euro area far exceed the growth rates of domestic business in almost all areas of activity.

Residency-based statistics, such as the statistics on the euro area OMFIs, may underestimate the importance of international claims (and liabilities), as they do not take into account the business carried out by the affiliates of banks in other countries. The establishment of foreign branches and subsidiaries has made a significant contribution to the integration of banking in the Single Market, even though it is only in Belgium, Ireland and Luxembourg that the market shares of banks from other EU countries are significant.

On the basis of the Consolidated International Banking Statistics issued by the Bank for International Settlements (BIS), international claims do indeed seem to be significantly larger when the assets of foreign affiliates are taken into account. The international claims of the OMFI sector currently represent around 18% of total assets, while the claims reported by the BIS are 22% of total OMFI sector assets. The difference is likely to be larger in reality, owing to the smaller sample size of the BIS statistics. In any event, the aggregated figures underestimate the importance of international credit exposures for the largest, internationally active banks. On the basis of the BIS statistics (June 1999), the cross-border claims of euro area banks seem to be concentrated, to a significant degree, in the euro area and the EU as a whole. Around 37% of all international claims of euro area banks are vis-à-vis other euro area countries, and 55% vis-à-vis other EU Member States.

Growing diversification of euro area banks' securities portfolios

A much sharper trend towards international diversification emerges when looking at the composition of the securities portfolios of euro area banks. The introduction of the euro has encouraged increasing diversification of investment on an industry rather than on a country basis. The share of domestic instruments in total holdings of fixed securities by euro area banks has decreased steadily since 1997. The trend is particularly strong in the case of government bonds, since holdings of domestic securities decreased by 6% in 1999, while instruments issued by other euro area governments rose by 38%. However, holdings of fixed income securities issued by non-bank private companies from other euro area countries also increased substantially (23%), compared with domestic business (8%) in 1999.

Increasing asset management activities also contribute to the expansion of cross-border activities

A balance sheet analysis does not provide a full picture of the cross-border activities of banks, since many services increasingly provided by banks are not reflected in corresponding balance sheet items. These activities generate fee and commission income rather than interest income. The share of banks' operating income generated by non-traditional activities – such as capital market-related investment banking and asset management services – has generally been on an increasing trend. In the first year following the introduction of the euro, private capital market activities expanded noticeably, with markets becoming increasingly integrated (see the article entitled "The euro area one year after the introduction of the euro" in the January 2000 issue of the ECB Monthly Bulletin). Banking organisations carrying out activities in increasingly integrated capital markets are more exposed to market shocks originating beyond their national borders.

Restructuring of the banking industry

The introduction of the euro has also provided an incentive for the reorganisation of the banking industry, which is being closely monitored by supervisory authorities.

Clearer distinction between large banks providing a full range of services and smaller specialised institutions

The consolidation process in the euro area has resulted in a much clearer distinction between the large institutions which supply a full range of services and the various smaller institutions usually specialised in some geographic or product segment of the market. The size of large banks has increased significantly in practically all euro area countries and more business has been concentrated with them. This increase in concentration took place earlier in the smaller countries and has recently quite clearly also involved the larger countries. While there are obviously a large number of differences between countries, this shrinking class of "middle-sized – non-specialised – banks" seems to be a common phenomenon. The number of small banks which are specialised in geographical or product terms has decreased, but these institutions seem capable of coexisting with the large institutions.

Increased merger and acquisition activity

The substantial deals carried out in 1999 suggest that the tendency to create very large entities has recently accelerated (see Table 6). Moreover, the average value of bank

Table 6

Major mergers and acquisitions involving euro area banks during 1999

Banks involved (bidder-target)		Assets at end 1998 [1] (EUR billions)
– Deutsche Bank (Germany)		604
– Bankers' Trust (United States)		114
	Total assets:	718
– Banque Nationale de Paris BNP (France)		325
– Paribas (France)		249
	Total assets:	574
– ING Group (Netherlands)		395
– BHF Bank (Germany)		45
	Total assets:	440
– Générale de Banque – General Bank (Belgium)		208
– ASLK/CGER Bank (Belgium)	(now within the Belgian-Dutch Fortis Group)	80
	Total assets:	288
– Banca Intesa (Italy)		153
– Banca Commerciale Italiana (Italy)		113
	Total assets:	266
– Banco Santander (Spain)		154
– Banco Central Hispanoamericano (Spain)		82
	Total assets:	236
– Crédit Communal de Belgique (Belgium)		105
– Crédit Local de France (France)	(now within the Dexia Group)	99
	Total assets:	204
– Banco Bilbao Vizcaya (Spain)		132
– Argentaria (Spain)		70
	Total assets:	202
– SEB (Sweden)		73
– BfG (Germany)		42
	Total assets:	115

Source: Assets from IBCA Bankscope.

1) Total assets are calculated "pro-forma" by adding up the consolidated assets of banks involved in the mergers.

mergers and acquisitions has strongly increased in the euro area, from around €200 million in 1997 to around €600 million in the first 11 months of 1999, according to data collected by the Securities Data Company. The annual number of bank mergers and acquisitions was around 400, on average, during the first half of the 1990s, compared with 200 in the latter half, indicating that the focus of merger and acquisition activity is indeed shifting towards larger institutions. Merger activity has had a significant domestic focus, but cross-border operations were quite important in 1999 and, compared with past evidence, are clearly increasing in relevance (see Table 6). These deals often involve banks located outside the euro area, reflecting significant links with other EU markets and, in the case of the largest institutions, global competition in some lines of business. These trends seem to be confirmed and reinforced by the operations publicised in the first quarter of the current year.

The increasing relevance of deals involving large credit institutions is related to the transformation of money and capital market activity in the euro area. Indeed, there seem to be significant economies of scale associated with asset management operations, either on the banks' own or on their customers' accounts, particularly following the introduction of the euro. In integrated money and capital markets, institutions need to process area-wide rather than national market information and may also need to be able to execute larger transactions than before. The bank consolidation tendency has been strikingly similar in the United States and in the euro area, despite the differences between the respective regulatory frameworks. This suggests that the forces at work are related not only to the transformation of the euro area money and capital markets, but also to the globalisation of financial markets in general and to technological innovation.

3 Institutional framework for banking supervision in the euro area

National competence and cross-border co-operation as guiding principles in banking supervision

The institutional framework for banking supervision established by Community law (notably the First and Second Banking Co-ordination Directives, as amended by the "post-BCCI" Directive) relies on two building blocks: national competence (based on the principles of "home-country control" and "mutual recognition") and co-operation. Supervisory responsibilities are at the national level, closest to those institutions which could give rise to financial stability concerns. This structure favours timely access to information and allows a detailed monitoring of banks' activities. According to the home-country control principle, every bank has the right to provide its services throughout the EU by virtue of a single licence, while being subject to the supervision of the authority of the country where it was licensed. At the same time, to avoid the possible drawbacks of a fully decentralised approach vis-à-vis an increasingly integrated market, the principle of co-operation between the responsible authorities is forcefully stated within the institutional framework of the EU.

Separation of central banking and banking supervision

If attention is focused on the euro area, an additional element has to be taken into consideration, since a dual separation of central banking and banking supervision, both geographical and functional, was introduced at the start of Stage Three of EMU. For the 11 Member States participating in Monetary Union, the jurisdiction of the central bank (the euro area) no longer coincides with the jurisdiction of

Table 7

Banking supervision arrangements in the euro area

	Authority responsible for banking supervision	Position vis-à-vis the government and funding of activities	Composition of decision-making bodies	Scope of supervisory responsibilities beyond the banking sector
Belgium	Commission Bancaire et Financière	Autonomous public institution, self-financed by supervised entities	Collegial body comprising a President, a member of the Board of the National Bank of Belgium and five other members	Investment firms and collective investment schemes; market disclosure.
Germany	Bundesaufsichtsamt für das Kreditwesen	Dependent on the Ministry of Finance; a high percentage of the costs incurred is refunded by supervised entities	President nominated by the Federal Government and appointed by the President of the Federal Republic of Germany, after consultation with the Deutsche Bundesbank	Investment firms, open-ended collective investment schemes and providers of financial services other than insurance companies
Spain	Banco de España	Independent central bank	Board of the Banca de España	None
France	Commission Bancaire	Autonomous public institution; strong links with the Banque de France (which provides the staff and the budget of the General Secretariat)	Collegial body chaired by the Governor of the Banque de France and comprising the Head of the Treasury and four other members	Investment firms
Ireland	Central Bank of Ireland	Independent central bank	Board of the Central Bank of Ireland	Investments firms; setting requirements for stock exchanges and authorised member firms
Italy	Banca d'Italia	Independent central bank	Governor	All financial institutions (except insurance companies) and wholesale markets, for government securities
Luxembourg	Commission de Surveillance du Secteur Financier	Autonomous public institution, self-financed by supervised entities	Chief executive appointed by the Grand-Duc of Luxembourg	All financial institutions (except insurance companies) and markets
Netherlands	De Nederlandsche Bank	Independent central bank	Board, collegial decision-making body	Collective investment schemes
Austria	Ministry of Finance	Part of the Government	Minister of Finance	Insurance companies
Portugal	Banco de Portugal	Independent central bank	Board of the Banco de Portugal	Investment firms
Finland	Financial Supervision Authority	Autonomous public institution, self-financed by supervised entities; strong links with Suomen Pankki	Collegial body, chaired by a member of the Board of Suomen Pankki	Investment firms and stock exchanges

Central bank involvement in banking supervision	Formal co-ordination arrangements between the banking supervisor and the central bank	Other authorities with responsibility for banking regulation	Other authorities involved in granting and/or in withdrawing the banking licence	
No specific supervisory tasks	Board participation	The central bank is consulted on prudential regulations and accounting principles	None	**Belgium**
Extensive involvement in the supervision of individual institutions; right to be consulted in many cases	Legal obligation to co-operate closely	Ministry of Finance; Ministry of Justice concerning bank accounting and disclosure; the central bank is consulted	The central bank is consulted	**Germany**
Full responsibility	Same authority	None	Ministry of Finance	**Spain**
Extensive involvement	The Governor of the Banque de France chairs the Commission Bancaire and the CECEI and is a member of the CRBF; administrative links	Comité de la Réglementation Bancaire et Financière (CRBF)	Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI)	**France**
Full responsibility	Same authority	None	None	**Ireland**
Full responsibility	Same authority	Comitato Interministeriale per il Credito e il Risparmio (CICR); Minister of Treasury	Minister of Treasury for liquidation procedures	**Italy**
No direct involvement	None	None	None	**Luxembourg**
Full responsibility	Same authority	None	None	**Netherlands**
Extensive involvement in the supervision of individual institutions; right to be consulted in many cases	Expert Commission composed of members of the Ministry of Finance and of the central bank	The central bank is consulted	The central bank is consulted	**Austria**
Full responsibility	Same authority	Ministry of Finance	None	**Portugal**
No specific supervisory tasks	Board participation and administrative links	Ministry of Finance	Ministry of Finance	**Finland**

the supervisor (nationally chartered institutions). Accordingly, institutional mechanisms have been devised in order to enable the central bank and the supervisory authorities to share information and to combine efforts whenever necessary.

Current supervisory structures

Diversity in national supervisory structures

Institutional arrangements for banking supervision show diversity within the euro area. There are only three euro area countries – Belgium, Luxembourg and Finland – where the national central bank (NCB) is not directly involved in banking supervision (see Table 7). In the other eight countries the NCBs are extensively or even exclusively entrusted with banking supervisory tasks. In Spain, Ireland, Italy, the Netherlands and Portugal the NCB is the sole body responsible for banking supervision. In France, Germany and Austria the separate supervisory agencies have close links with the NCBs. This is also true for Finland. In Finland and France the supervisory agencies are chaired by a representative of the relevant NCB (a member of the board of Suomen Pankki and the Governor of the Banque de France respectively), information is shared and the staff can move freely between the two institutions. In Germany the Deutsche Bundesbank has the right to be consulted on a variety of supervisory issues, co-operates with regard to on-site examinations and collects information on behalf of the responsible supervisory authority. Similar activities are performed by the Oesterreichische Nationalbank in Austria. Various institutional changes are currently being discussed in some euro area countries: plans to create new supervisory agencies have been presented in Ireland and the Netherlands, while a move in the opposite direction, increasing the involvement of the NCB in supervisory issues, is being debated in Austria.

Where the prime responsibility for banking supervision does not lie with an NCB, the relationship between the supervisory agency and the government varies from country to country. In Germany and Austria the banking supervisory agency is part of the government sector (in Austria responsibility is in fact entrusted directly to the Ministry of Finance). In other countries the agency is an autonomous public institution, managed by a collegial body in which representatives of the industry may also have a seat, often alongside government representatives. In addition, in the latter case, the agency is frequently self-financed through contributions from the supervised entities.

Where the NCB is not directly entrusted with responsibility for banking supervision, mechanisms for co-operation with the responsible authority are usually in place (e.g. board participation, joint committees and administrative links).

The scope of supervisory functions beyond the banking sector does not strictly depend on NCBs' involvement in supervision in the euro area. Generally speaking, where responsibility for banking supervision is not entrusted to the central bank, the agency has some role in monitoring non-bank financial institutions and markets. However, the scope of activity never extends so far as to embrace all segments of financial activity, along the lines of the conglomerate agency model which has been adopted in the United Kingdom and Sweden. In the euro area NCBs are frequently also in charge of supervising non-bank financial institutions and markets. In Italy, for instance, the Banca d'Italia carries out prudential supervision of all financial institutions except in the area of insurance, while the Italian Securities Commission (Consob) is in charge of controls aimed at ensuring transparency and investor protection. As a rule, when the central bank is involved in the supervision of non-bank financial institutions and markets, this function is usually related to systemic stability, while consumer protection issues play a larger role in the case of separate supervisory agencies.

Finally, in most countries other bodies are also involved in banking regulation and in granting or withdrawing bank licences.

Despite diverse institutional structures, harmonised regulations are applied in euro area countries

Banking supervision in the euro area as well as in the EU countries, while performed by different institutional structures, is based on a core set of harmonised concepts and rules, provided by the Community Directives issued thus far for the banking sector. The First and Second Banking Co-ordination Directives establish the three working principles for the single banking market: the minimum harmonisation of rules, mutual recognition of authorisation and supervisory practices and home-country control. On the basis of a common notion of the credit institution, objective criteria for bank licensing, branching and the cross-border provision of services have been harmonised. In the same manner, basic prudential requirements in relation to capital adequacy and large exposures have been developed and implemented in all Member States, on the basis of a harmonised definition of own funds.

General rules for the preparation of the annual and consolidated accounts of banks have also been harmonised since the mid-1980s. The principles concerning consolidated supervision were agreed in 1983 and then reinforced in the aftermath of the BCCI crisis. The need for extensive exchanges of information between competent authorities has been stressed, while the legal obstacles to the sharing of confidential information, also with central banks, have been removed at the Community level. Lastly, it should be noted that rules on exiting the banking market are still largely domestic. In this area, some harmonisation of the framework for deposit insurance schemes has already been achieved, while the Financial Services Action Plan presented by the European Commission in 1999 has recognised the need to finalise the work on a Directive relating to the reorganisation and winding-up of credit institutions. The Banking Advisory Committee is responsible for assisting the European Commission in preparing Community legislation relating to the banking sector and in monitoring its implementation.

The operational conduct of supervision, as well as the detailed implementation of the principles laid down in relevant EU legislation, also exhibit, to some extent, national peculiarities. Supervisory authorities rely to a different degree, for instance, on on-site examinations and off-site surveillance. In addition, the weight of administrative procedures, as opposed to a style of supervision based on regular contact with the management of the banks, varies from country to country. The strategies for taking corrective measures in cases of bank fragility also differ to a certain extent. As far as the implementation of relevant EU legislation is concerned, divergent national legal traditions may influence the interpretation of guiding principles, such as the prerequisite of suitability and propriety of bank managers. Furthermore, the harmonised framework for deposit insurance (through the specific Directive) leaves some scope for differences in the coverage, administration and funding of domestic schemes.

These differences do not necessarily hamper the integration of the euro area banking market, but they do allow for monitoring and corrective measures which are best suited to specific national environments. As long as the significance of cross-border activities increases, there will be a market-driven process of regulatory competition. In the medium term, this may be very helpful in preventing the spread of unnecessarily cumbersome regulations and in selecting the best supervisory practices.

Outside the realm of prudential regulations, there are fields in which national arrangements still differ widely, possibly also affecting the scope and the pace of integration in the euro area banking market. This is the case with tax rules; differences within the euro area may well have affected decisions taken by major banking groups to organise certain activities in subsidiaries and to locate them in such a way as to minimise the tax burden. Moreover, the absence of a common framework for takeover bids or, more generally, for corporate law, may influence the restructuring of the industry, possibly determining significant discrepancies in the functioning of mechanisms for corporate control.

Co-operation among authorities

To the extent that national supervisors, applying commonly agreed principles, are able both to prevent excessive risk-taking by the banks they oversee and to take effective corrective measures, the soundness of the euro area banking system will be promoted. However, strengthening co-operation between competent authorities is deemed necessary to deal with the increasing scope of cross-border activity. The blurring of distinctions between different financial contracts, as well as the existence of multi-business conglomerates, also calls for extensive reliance on cross-sector co-operation, involving banking, securities and insurance supervisors. This issue is currently being addressed at the EU level.

The need for co-operation in banking supervision has been heightened by the introduction of the euro

First of all, the clear-cut separation between the jurisdiction of the single monetary policy and that of national supervisory policies has determined the need for co-ordination mechanisms aimed both at sharing information whenever necessary and at contributing to a common stance on financial stability issues of mutual interest. Second, disruptions in the banking system frequently stem from abrupt changes in the macroeconomic environment or relevant sectors of the economy. Since these developments in the euro area are gradually becoming more closely interwoven, an area-wide view is needed to complement national perspectives on risks to banking stability. Although most retail markets are still nationally, if not regionally, segmented, common factors are increasingly likely to affect the choice of banking institutions across the euro area as well as their risk exposures. Third, as discussed in the second section of this article, elements of fragility may well arise from capital market activities (e.g. asset management and investment banking) and other businesses which are already assuming an area-wide dimension. Moreover, as the introduction of the euro and the single monetary policy have substantially altered the functioning of the money market and the network of exposures in the interbank market, a drying-up of liquidity, causing distress in banking institutions, is unlikely to be contained within domestic borders. The risk of cross-border contagion is correspondingly greater.

The instruments for co-operation are already in place

The instruments for co-operation already established are flexible enough to be modified on an ongoing basis. In view of the further integration of the banking and financial industry in the euro area, they will have to be used more extensively and developed further in order to facilitate joint preventive and corrective actions by European supervisory authorities. In fact, most of these instruments have an EU, or even a European Economic Area (EEA), dimension. The following, however, focuses on a euro area perspective.

The Memorandum of Understanding is the key instrument for bilateral co-operation. It functions as the basic channel for the exchange of information between home and host-country supervisors and for facilitating consolidated supervision. Memoranda of Understanding have been very widely agreed, and typically include practical provisions concerning the establishment of branches and subsidiaries and cross-border investigations. Using this instrument, most co-ordination problems arising from the expansion of cross-border banking through branches and subsidiaries can be addressed by two authorities (home and host country).

The other main mechanism in place is co-operation through committees. In this case, co-operation is undertaken on a multilateral basis, assuming the perspective of the whole area of joint responsibility. From the point of view of the Eurosystem, the Banking Supervision Committee (BSC; see Box), established by the Governing Council of the ECB, is the relevant forum for addressing the issues raised by the introduction of the euro and for promoting supervisory co-operation. It includes banking supervisors and central banks of the EU countries, as well as the ECB, and is entrusted with a twofold responsibility.

First, it facilitates co-operation between the Eurosystem and national supervisory authorities. The BSC has the function of giving

Box

Banking Supervision Committee

The Banking Supervision Committee (BSC) was established as an ESCB Committee in June 1999, taking over the functions previously fulfilled by the Banking Supervisory Sub-Committee established at the European Monetary Institute. It is composed of high-ranking officials from supervisory authorities and central banks of the EU countries and is currently chaired by a member of the Board of the Deutsche Bundesbank. Its mandate is to assist the Eurosystem in the fulfilment of its statutory tasks in the field of the prudential supervision of credit institutions and the stability of the financial system. In this context, the BSC performs three basic tasks:

1. pursuant to Article 105 (5) of the Treaty, it promotes co-operation on issues of common interest to banking supervisors from the EU countries and the Eurosystem;

2. in accordance with Article 105 (4) of the Treaty, it assists in the preparation of ECB Opinions on draft Community and national legislation on banking supervision and financial stability; and

3. pursuant to Article 25.1 of the Statute of the ESCB, it assists in the preparation of ECB advice on the scope and implementation of Community legislation relating to banking supervision and financial stability.

In addition, the BSC has a mandate to act as a forum for consultation among EU banking supervisors on issues not relating to the tasks of the Eurosystem.

In order to accomplish its tasks, the Committee has established four working groups, in charge of addressing issues related to: (i) structural developments affecting the banking industry; (ii) the soundness of banking and financial structures ("macro-prudential" analysis); (iii) supervisory risk assessment systems; and (iv) credit registers. In the conduct of these tasks, a number of reports and documents have been prepared so as to offer an EU/euro area perspective on a wide range of issues. The issues addressed include, inter alia, the impact of EMU on banking structures, the effects of technology on banking activity, the income structure of EU banks, mergers and acquisitions, the exposure of EU banking systems to emerging market countries, the effects of asset prices on banking stability, the operation of supervisory risk assessment systems and the use of information from credit registers. The BSC also serves as a channel for conveying to the supervisory authorities any useful information on credit institutions which the ECB and the NCBs might gain from the performance of their basic tasks in the field of monetary policy and payment and securities settlement systems. At the same time, it allows the reverse flow of information from supervisory authorities to the Eurosystem to be managed. For a description of the activities carried out by the BSC during 1999, see Chapter VI of the ECB's Annual Report 1999.

content to the provision of Article 105 (5) of the Treaty, in accordance with which the Eurosystem is assigned the task of "contributing to the smooth conduct of national policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". In doing so, it contributes to the formation of an area-wide perspective on a variety of issues, in such a way as to complement national views on stability issues and to foster the emergence of common stances vis-à-vis the challenges posed by an increasingly integrated banking system. Analytical efforts are mainly concentrated on the structural changes affecting the banking business and on the soundness of banking and financial structures ("macro-prudential" analysis). Within this framework, any development in the market-place raising potential concerns is jointly analysed; the focus is on possible threats to stability and, if necessary, on remedial measures. In addition, the BSC serves as a channel for bilateral flows of information between the Eurosystem and national supervisory authorities.

The second responsibility of the BSC is to foster co-operation between supervisors, beyond the interests of the Eurosystem. Hence, it is also in a position to enable EU supervisors to take co-ordinated positions and measures in response to market developments. The BSC aims to strengthen co-operation with regard to supervisory instruments, to a large extent alleviating the potential repercussions of differences in national arrangements and favouring the development of commonly agreed supervisory practices.

In addition, the Groupe de Contact, a committee of EEA banking supervisory authorities, established as a forum for multilateral co-operation in 1972, addresses issues relating to the implementation of banking regulation and supervisory practices, including the discussion of individual cases.

The overall framework for co-operation within the euro area essentially aims at reinforcing preventive measures against bank fragility. However, in cases of instability, the same framework can be used to deal with any cross-border implications of such a crisis and to limit contagion effects. Supervisors stand ready to inform the Eurosystem as soon as a banking crisis arises, and the BSC is in a position to address the relevant issues. The need for a timely exchange of information is essential in order to enable competent national authorities to deal with any cross-border implications.