FINANCIAL SUPERVISION ARRANGEMENTS: EXPERIENCE AND PERSPECTIVES

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Abstract: *The surveillance of financial markets has always been a preoccupation of decision makers, but the present crisis requires a reconsideration of former arrangements in order to deal with vulnerabilities and contagion. Traditionally, separate authorities ensured the supervision of banks, capital markets, insurance companies, given their rather small scale activity and specificities. But, the ongoing changes concerning the portfolio of financial products that have occurred during the last two decades have strengthened the connections among financial institutions. The paper analyses the manner The Bank of England and The European Central Bank have reconsidered the architecture of the regulatory and supervisory system to meet the challenges raised by the recent crisis. The main conclusion of the study is that there is no one size fits all supervising system and that its architecture depends on the specific financial history of a country, its economic development, culture, the concentration and openness of their financial systems, etc.*
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IDENTIFYING THE PROBLEM

Regardless of the regulatory and supervisory architecture, the prudential policies consider: the safety and stability of the financial institutions, deposit insurance, the safety of the payment systems, the business conduct, business ethics, etc.

The active involvement of Central Banks in the surveillance system is supported by the wide experience of these institutions, the professionalism of central bankers, their competitive advantage, the ability to manage systemic risks, the lender of last resort stance, etc. On the other hand, there are authors that oppose the active supervisory role of

Central Banks arguing that they would become too powerful and their involvement on the financial market too deep (Volcker *et al*., 2008).

Nevertheless, empirical researches show that in 89 countries out of 136, the Central Banks are the sole supervisory authorities of the domestic banking systems, in 9 countries, including the USA, Central Banks are involved in supervising the financial sector, at large, besides the specialised authorities, while in 38 countries the Central Banks are not among the supervisory authorities (Barth, Caprio & Levine, 2013). Recent studies (Llewellyn D, 2006 apud Masciandaro, 2003) on the correlation between the concentration of supervision and the supervisory role of Central Banks show that the higher the role of these institutions, less concentration of supervision occurs. On the contrary, when there is a higher degree of financial concentration it is not the Central Bank that acts as supervisory authority. Goodhardt (2011) argues that Central Banks are more appropriate supervisory authorities than other agencies because their ability to control the liquidity, and promote stability measures in the financial system.

The present crisis has marked a shift in the supervisory systems: if 15 years ago a rift occurred in associating Central Banks with prudential supervision, nowadays their regulatory and supervisory role in preventing risks and in ensuring macro stability is reconsidered (Trichet, 2013).

The supervision of banking systems became a wide preoccupation of theoreticians and practitioners worldwide, since the new challenges raised by the economic and financial crisis posed the need for new approaches of the monetary decision makers. Presently, the design of financial supervision includes: the *institutional, functional, integrated and twin peaks* approaches, according to the policy makers and regulators views. The decision to employ one of these alternatives depends on the characteristic of the financial systems, the expected vulnerabilities that may occur, the resolutions of previous crises, historical precedence, financial culture, social capital, etc.

The institutional approach refers to the possibility of banks and other financial institutions (stock brokers, insurance companies, etc.) to decide on the regulator that will oversee the soundness of the business. As a traditional supervising system, it is nowadays challenged by the dynamic changes that occur on financial markets that become more interchanged. Therefore, China, Mexico and Hong Kong have revised the approach through various coordination mechanisms.

According to *the functional approach*, each financial business may be submitted to its own functional regulator. It was of common use in the Mediterranean group of countries: Italy, Spain as well as France and Brazil, but because its suboptimal structure, these countries preferred to slide towards integrated or twin peaks approach.

The integrated approach refers to a single regulator that supervises the soundness of all the financial sectors, allowing a unified oversight of a large variety of financial services, eliminating possible redundancies had supervision been exercised by several authorities. It proved to be effective on small financial markets and therefore countries with larger, more developed financial markets, i.e. Canada, UK, Germany, Japan, etc. that have previously used the integrated approach and were confronted with coordination difficulties, were forced to revise it.

The twin peaks approach is an objective based surveillance system, separating the regulators that oversee the soundness of financial institutions and regulators that focus on conduct of business. The advantage of the approach is that it incorporates the effectiveness of the integrated system, but also considering its shortfalls in dealing with possible conflicts in pursuing financial soundness and the transparency consumers expect. The twin peaks approach is used by The Netherlands, Australia and the USA, but the weaknesses of the system triggered debates concerning the need of alterations in its functioning. The consolidation of the Dutch financial system in the early 1990s led to the adoption of this model. In this case, The Central Bank is the supervisory authority of the financial market, while another authority is responsible for the business ethics. This approach pursues the specialisation of various supervisory authorities on the following objectives: financial stability, prudential supervision, business ethics, providing the safety nets for savings and market competitiveness. This model reflects the rational changes that took place in the financial industry that were acknowledged as more effective.

There is a large support for this type of supervising arrangement that separates prudential supervision of the business ethics monitoring. The model was conceived in such a manner as to combine the advantages and effectiveness of the integrated model, mainly the conflict of interests. Moreover, this model allows a clear cut distinction and a greater compatibility between the attributes of the supervising authorities and the fair competition requirements because the same prudential rules are applicable to all institutions.

2. THE REFORMATION OF THE REGULATORY ANS SUPERVISORY SYSTEMS

2.1 The reformation of the regulatory and supervisory architecture in the EU

The 2007-2008 economic and financial crises emphasises the concept of systemic risk and the necessity to reconsider prudential supervision. The characteristics of the crisis show that solely the prudential supervision cannot guarantee financial stability. Therefore it is an urgent need to detect systemic risk and adopt the appropriate remedies. The main challenge in analysing systemic risk is to integrate all the relevant perspectives and have a comprehensive view on system, its dynamics and interconnections (Trichet, 2013).

The first official steps in the macro prudential supervision were taken in 2011 when the European System of Financial Supervision was created based on two tiers: the macro prudential tier *The European Committee for Systemic Risk* and the micro prudential tier that includes separate authorities for the banking system, the capital market, insurance, and pension funds.

The next important step is the creation of the European Bank Union. The European Commission enforced the same prudential norms on the banking systems, requesting that the supervision should be exercised by a single authority. Thus the sole supervisory competence belongs to the European Central Bank.

The main objectives of the Single Supervisory Mechanism are the safety and the stability of the financial markets in Europe. The ECB will cooperate with the national authorities of the EU member states. Within the new mechanism, The ECB will directly supervise the 130 significant credit institutions that own 85% of the entire banking assets in the Euro zone. Moreover, it will supervise at least three important credit institutions, while all the others will fall under the competence of national supervising authorities.

A major accomplishment at European level was the approval of the single rulebook, its aim being to consolidate the resilience of the EU banking system and to restore trust.

2.2 The British approach

In Great Britain, a major reform of the regulatory and supervisory system took place in 1998 when the „*Financial Stability Authority*" (FSA) was created. The reforms included a better cooperation of the supervising agencies. Thus the FSA cooperates with the Treasury and The Bank of England in the frame of a Memorandum. Moreover, the deputy Governor of The Bank of England is member of the FSA board while the president of the FSA is member of the Court of Directors of the Bank of England. The 2009 Bank law entrusted the Bank of England as guardian of the financial stability and supervisor of the payment system. (ECB, 2010)

In April 2013, a new regulatory framework came into force under the Financial Services Act 2012. The Financial Services Act 2012 brought significant changes to the regulatory framework of financial services in the United Kingdom, many of which impacted on the role of The Bank of England. The FSA, responsible for regulation of financial firms from both a 'prudential' and 'conduct' perspective, will cease to exist.

The Prudential Regulation Authority (PRA) is part of the Bank of England undertaking the responsibility for the micro prudential regulation of deposit-takers, insurers and major investment firms. The PRA will set the standards of supervising financial institutions at the level of the individual firm, promoting safety and soundness, seeking to minimise the adverse effects that they can have on the stability of the British financial system, thus contributing to ensuring that insurance policyholders are protected. The Financial Conduct Authority (FCA) is a separate institution from the Bank of England, responsible for ensuring that the main markets function appropriately and effectively. Its main objective is to protect consumers, the integrity of the British financial system and promote effective competition. The FCA will be responsible for the conduct and ethical regulation of all financial services firms, i.e. to prevent market abuse and ensuring that financial firms treat customers fairly. The FCA will also be responsible for the micro prudential regulation of financial services firms, e.g. asset managers, hedge funds, many broker-dealers and independent financial advisers that do not fall under the jurisdiction of the PRA.

The Bank of England will continue to pursue financial stability, having a statutory objective to protect and enhance the stability of the financial system of the United Kingdom. Financial Policy Committee identifies monitors and takes measures to remove or alleviate systemic risks that threaten the financial system as a whole, rather than at the level of the individual firm (Murphy & Senior, 2013).

3. CONCLUSIONS

The traditional hypotheses concerning the regulatory and supervisory structure were debated at length by theoreticians and practitioners as well. Lately, new regulatory and supervisory structures were implemented at national and international level, given that the financial innovation led to an ever more complex financial system meaning that supervision couldn't be concentrated exclusively at the banking sector.

The main determinants of these changes were:

The globalisation of financial operations intensified the international dimension of the regulatory systems that impacted on the national supervisory architecture;

2. The objectives became more extensive and complex. It became questionable whether an excessively great number of agencies raise the costs of supervision as well as its complexity;

3. Irrespective of the institutional structure, the financial conglomerates emphasize the necessity to have a consolidated view on each financial institution;

4. The changes in the institutional structure were a response to the present crisis, which emphasizes the concept of systemic risk and the necessity of its macro prudential supervision. The need of an institutional structure with a broader view over the entire financial system was identified as mandatory to detect the potential vulnerabilities;

But, as the latest developments show, the recent crisis was a result of too little regulations and lack of coordination and communication among central banks and supervisory authorities.

The debates on the architecture and effectiveness of different regulatory and supervisory systems continue since no widely accepted solutions were yet identified. There is a substantial heterogeneity of views concerning the supervisory policies worldwide, each country choosing the approach that best answers its specific circumstances.

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