Designing a Regulatory and Supervisory Framework for Integrated Financial Markets

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Abstract

The financial crisis that started in 2007 casts doubt about the ability of national laws and competent authorities to manage the stability of the financial system and to protect investors. This is due to the relevant evolving features of financial intermediation, like the cross-border strategies in banking, with many M&A undertaken, especially in Europe, and more in general the globalization of finance, also through the many recent operations among exchanges. The associated regulatory and supervisory challenges have proved to be difficult to tackle.

An international perspective is needed on single banking regulatory instruments, even if it is impossible at this stage to imagine unique rules and single international authorities managing capital ratios, deposit insurance, reserve requirements and lending of last resort, as well as other tools for providing financial markets stability. However, some common principles on regulation and the structure of supervision may be stated both in US and in Europe: we suggest a "four peak" approach to the matter.

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1. Introduction

In modern industrial countries, financial markets have rapidly evolved in the last decades. The new technologies and the progress in information communication and disclosure have also induced a growing globalization of finance. This path can be observed with regard to banking and financial intermediaries, capital markets and financial instruments. On one side, there is an increasing integration of functions, instruments and agents in the financial sector. Banks, capital markets, insurance companies and other financial institutions like investment, hedge and pension funds show increased interdependence and multidimensional linkages. Large groups are emerging offering a full range of financial services and products. On the other side, such integration, which had previously a largely intra-national path, has become increasingly international: this has been favored by the adoption of a single currency in the euro area but also by the increasing consolidation among securities exchanges as well as post trading operators in the world.
Mergers offer more opportunities and allow to exploit economies of scale and scope. At the same time, they could lead to excessive risk concentration.

In the summer of 2007, the subprime crisis, announced by the difficulties of some leading US hedge funds has had an impact on monetary and financial markets throughout the world. Risk premia have increased everywhere. Rating agencies have been blamed for having failed to warn the market. The awkwardness of supervisors and the failure of the tripartite agreement of the three UK financial regulatory authorities at its first stress test has been accompanied by a true bank run in the UK: an event that probably no-one alive would have ever imagined could happen again.

The crisis of Autumn 2008 (still running while we are writing) is changing the structure of the financial industry. We have seen: a hysterical run by the regulatory authorities in stopping short selling; late night meetings of EU ministers to bail-out transnational banks; the frantic decision throughout Europe of raising deposit insurance coverage up to non-credible limits (many times the GDP); repeated crashes of indexes despite massive liquidity injections by central banks; the complete freezing of the interbank market; brutal exchanges downsizing; and panic of the regulators. A plausible (and likely) outcome is the nationalization of an entire industry, with some big investment banks disappearing and others being transformed into commercial banks. If ever the industry survive, international steps in order to avoid that something like this will happen again must be taken. In fact, despite the continuous reforms in financial regulation in different countries, described in the following section, national policy makers and authorities resist and are actually reluctant to accept more stringent links with foreign authorities and considerable transfer of powers. The problem must clearly be tackled in different ways for different geographical areas. It is not realistic at this moment to think about world regulators or world rules even if regulatory and supervisory cooperation is not sufficient any more. It has been widely argued, however, that a reorganization in the structure of regulators in the United States (GAO, 2007; US Treasury, 2008) as well as in Europe is necessary (Di Giorgio and Di Noia, 2006).

The paper is organized as follows. We start by describing some regulatory features that have emerged in connection both with the process of cross border and cross sector integration in finance and with the recent financial crises. In section 3, we briefly present the current state of financial regulation and supervision in Europe and US, as well as some recent regulatory initiatives which have been proposed in those countries. We discuss our own proposal for the reorganization of the architecture for financial regulation and supervision in section 4. Finally, we summarize and conclude in section 5.

2. Integrated financial markets, regulation and crises.

The definition of the term 'financial market' has traditionally included banking, financial and insurance segments of the industry. In the past, the boundaries dividing institutions, instruments and markets were clear-cut, so that further distinctions were drawn within the different classes of intermediaries (with banks specialized in short or medium/long term maturities, functional/commercial operations, deposits and investments; with financial intermediaries handling broker-dealer negotiations, asset management and advisory functions, and with insurance companies dealing in life and other insurance policies).

The process of financial integration has produced a common space where all financial activities are now undertaken by entities that, although sometimes legally different, do actually perform the same economic functions and manage similar products. The situation is extreme in the case of large intermediaries that have been called “conglomerates”. Probably, a distinction must be taken between "financial conglomerates" whose interests are exclusively, or predominantly, in financial activities and "mixed conglomerates." Mixed conglomerates are predominantly commercially or industrially oriented and contain at least one regulated financial entity in some part of their corporate structure. Here, we deal with financial conglomerates, defined as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)" (Bank for International Settlements, 1995). Many of the world's prominent financial firms are indeed conglomerates. In 2000, over 80% of the assets of the largest 500 banking organizations were controlled by conglomerates. Among the largest 50 banking organizations, the proportion of conglomerates was 94%. The share of banking assets controlled by conglomerates has been increasing in both developed and developing countries. Most of these large conglomerates are active internationally (Huerta, 2005). If we take a look at the EU we can find about 68 conglomerates[1] according to the 2002/87 directive, other 2 are in Switzerland, 6 in the US and 1 in Australia. In general, these conglomerates operate in 2 countries; with a few exceptions they are present in more countries (Allianz, for example, is an insurance group operating in 10 EU countries). The EU Directive sets out requirements on solvency, in particular to prevent the same capital being used more than once as a buffer against risk in different legal entities in the same conglomerate (multiple gearing of capital). Besides, it tries to ensure that the concentration of risk at group level, and transactions between entities in the same conglomerate, are appropriate. It also focuses on risk management and internal control systems. But the most important feature deals with the lead supervisor function: a single supervisory authority should be appointed to coordinate the overall supervision of a conglomerate. Many events in the last years show the difficulty of such arrangements and provide evidence of a multidimensional problem that includes geography, type of business, type of regulator, size of the supervised entities and bankruptcy arrangements. Some problems clearly arise from regulation and supervision. Even in federal systems, like the US, or in common economic areas, like the EU, where a subset of countries has adopted a common currency, day to day regulation is never truly harmonized and financial conglomerates must set up different compliance arrangements and thus lose many of the advantages of integration. In the EU, the situation is even worse: the implementation tables by the EU Commission show an excellent track record of all the Member States[2]. However, despite the adoption of the Lamfalussy procedures for many of the financial services directives[3], in practice regulation is quite different in different countries. Some pieces of Level 1 directives are in the Member States' legislation, others in secondary regulatory arrangements (Level 2); at the same time pieces of Level 2 are in the national laws while others in the secondary regulations. Sometimes, the national Parliament and the competent authorities change substantially the Directives (going "beyond the floor" in the case of minimum harmonization, or "beyond the roof" in the case of maximum harmonization)[4]. The recent

[1] See http://ec.europa.eu/internal_market/financial-conglomerates/docs/200711_conglomerates_en.pdf.

[2] See http://ec.europa.eu/internal_market/finances/docs/actionplan/index/transposition_en.pdf.

[3] Level 1 of the Lamfalussy approach consists of framework Directives or Regulations. At Level 2, four regulatory Committees assist the Commission in adopting implementing measures, ensuring that technical provisions can be kept up to date with market developments. Committees of national supervisors are responsible for Level 3 measures, which aim to improve the implementation of Level 1 and 2 acts in the Member States. At Level 4, the Commission will strengthen the enforcement of EU law.

[4] See the problems arisen in the implementation of the market abuse in the report by ESME at

crisis also tested the EU supervisory arrangements in relation to financial conglomerates: despite the absence of a political and fiscal union, policy makers were relatively efficient in solving overnight the crisis of Fortis, even if the net result was the separation of the bank in different domestic entities.

It is wise to underline that even in a single country coordination mechanisms among different agencies prove to be difficult, especially during a crisis. Different existing regulatory models --"single regulator", "twin peaks", "institutional" or by nature of the intermediary (bank, insurance or securities) -- create frictions given the different objectives that an agency pursues. Even in the case of a single regulator, it is possible that different departments try to maximize different utility functions. A crisis acts as a stress test of a regulatory model. At the national level, typically the lender of last resort is the central bank providing liquidity to the whole market and/or to the (illiquid but not insolvent) commercial banks. In the Euro countries, it is not clear any longer who is in charge of the lender of last resort function. Different arrangements can be stipulated between the prudential supervisor and the central bank; but which one? The national one, the European Central Bank (ECB) or the European System of Central Banks (ESCB) as a whole? In the case of the recent bail-outs, all traditional instruments have been exploited (sometimes in a creative way): direct government intervention, central bank intervention, deposit insurance. And all types of intermediaries have been involved: commercial and investment banks, investment and hedge funds, investment firms, insurance firms; the traditional segmentation of banking, capital markets and insurance has been finally defeated by the events.

The current crisis does not seem to have been started by conglomerates per se: the big investment banks that were bailed out or failed were not conglomerates. Some big commercial banks have *de facto* become hedge funds because of their high leverage. Mistakes in financial regulation and supervision have been underlined: from pro-cyclical capital ratios, arising from both Basle 1 and 2, to the new accounting rules on fair value and mark to market; from the key role given to rating agencies by central banks (who wrote Basle 2 rules?) to excessive leverage ratios (by permitting to hold unlimited amounts of AAA-rated structured financial products). All this is relevant for a broad class of financial intermediaries. However, although in integrated financial markets financial conglomerates have a leading role and contribute either to spread out faster or to better absorb the crisis, no dedicated intervention has been produced in the form of any new and special supranational rule and supervisory measure explicitly tailored for these players. In an international context, and also with respect to conglomerates, the big cases of the last years,

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http://ec.europa.eu/internal_market/securities/esme/index_en.htm.

although in a different way (Herstatt, Drexel Burnham Lambert, BCCI, Barings and LTCM) show a "too complex to fail issue" (Herring 2005) where the lack of an international lender of last resort (Guttentag and Herring, 1983) or of a global deposit insurance scheme surely deserve further analysis (Fisher, 1999)[5]. But the events of the autumn 2008 (the bail out of Bear Sterns and AIG, the default of Lehman, the intervention of Bank of America in Merrill Lynch in the US; the near nationalization of the entire banking system in the UK and Germany; full guarantee provided on deposits and maybe other kind of liabilities) show much bigger problems than those specific to conglomerates. The enormous provision of fresh capital (through direct injection of capital, government loans or the purchase of toxic assets) and the new rules on deposit insurance show an elementary concept: a bail out, in any particular form, is (and must be) a decision whose responsibility falls only on the policy maker. The policy maker can be assisted by the financial market authorities and the central bank, but in a way that makes explicit that these entities are independent agencies. On the contrary, often in the recent past bail out decisions have been taken by central banks, as lender of last resort, or by the competent supervisory authorities (sometimes central banks). The intervention of an independent authority for bailing out carries out a relevant risk: the loss of independence and reputation. The net result of the Fed intervention in the AIG case is the loss of independence with respect to the US Treasury. The summer events of Northern Rock instead of showing only a "bank" panic have showed a "central bank panic" and the crash of any residual credibility of the UK authorities. The latter, scared by the queues at the bank, have publicly declared that they would have guaranteed all depositors and basically the bank, which was, *inter alia*, a listed company, thus introducing an asymmetry in the treatment of external investors that poses new and difficult questions.

While in the US the policy maker is federal (as well as the taxpayer), in Europe both of them are still national. This is the reason of the stubborn existence of national authorities that, while the ECB acts more or less in coordination with other central banks, do not show sufficient coordination in the analysis of the situation and in the sharing of confidential information. Current arrangements for coordinating national supervisory activities are overly complex and burdensome. They have proved incapable of ensuring efficient area-wide supervisory teamwork during a crisis. The Level 3 Committees (Committee of European Banking Supervisors, Committee of European Securities Regulators and Committee of European Insurance Occupational and Pension Supervisors), in spite of excellent but limited permanent staff, depend wholly on their constituent authorities and have rigidly tripartite competence (banks, securities and insurance) according to an obsolescent view of the regulatory and supervisory framework. This has two regrettable consequences. It creates an

[5] The management of the August 2007 subprime crisis resulted in a voluntary initiative by Citi and othe US big banks to create a new and dedicated fund to give liquidity to the subprime market.

extra regulatory burden entailing a loss of competitiveness for Europe's financial industry and it offers inadequate protection for investors. We must therefore now act decisively to enhance European supervisory structures. This applies in particular to the euro area, where a single payment infrastructure and a single liquidity source are in place.

3. The Current State of Financial Regulation and Supervision in Europe and the United States.

In each country, financial markets regulation has been affected by the structure and the evolution of the domestic financial system as well as by the legal system in place. Table 1 summarizes the current state of financial market regulatory and supervisory arrangements in the European Union and the United States.

The US situation

In the US, the structure of financial regulators and supervisors is quite complex. On the banking side, there are four Federal banking agencies: the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrifts Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). Furthermore there are fifty state banking departments. On the securities side, regulation and supervision are split among two federal entities: the Securities and Exchange Commission (SEC) and Commodity Futures and Trading Commission (CFTC). The former protects investors, maintains fair, orderly, and efficient markets, and facilitates capital formation through overseeing the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, listed companies and mutual funds. The SEC promotes the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud. The SEC outsources much of its oversight responsibility to two self-regulatory organizations, the NYSE and the NASD. The CFTC is in charge of derivatives markets. On the insurance side, there is no federal entity: fifty state insurance departments are in charge of regulation and supervision. Some sort of coordination on financial markets is ensured by the President's Working Group on Financial Markets whose members are the Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the SEC and the Chairman of the CFTC.

The current structure of financial regulation and supervision is cumbersome with overlapping agencies and increasing cost for the industry (Dearie and Vojta 2007). In October 2007, the US Department of Treasury (Treasury for short) has sought comments to a document[6] that asks how the regulatory structure of the U.S. financial system should be changed. According to this

[6] http://www.treasury.gov/press/releases/reports/federalregisternoticehp602.pdf

document, much of the basic regulatory structure associated with financial institutions was established decades ago. While there have been important changes over time in the way financial institutions have been regulated, the US regulatory structure has basically remained the same[7].

The recent GAO report on financial regulation underlines that the current US regulatory structure, with multiple agencies that oversee segments of the financial services industry, is challenged by a number of industry trends[8]. The development of large, complex, internationally active firms, whose product offerings span the jurisdiction of several agencies, creates the potential for inconsistent regulatory treatment of similar products, gaps in consumer and investor protection, or duplication among regulators. GAO has recommended several options to accomplish modernization of the federal financial regulatory structure; these include consolidating certain regulatory functions as well as having a single regulator for large, complex firms. Finally, as part of Secretary H. Paulson's initiative to strengthen U.S. financial markets' competitiveness in the global economy[9], the Treasury has published the "Blueprint for a modernized financial regulatory structure"[10]. The document proposes a new architecture for US financial regulation recommending a regulatory model based on objectives, to more closely link the regulatory structure to the reasons of regulation. The model is inspired by the Australian model and some academic literature (Herring and Carmassi, 2008; Di Giorgio and Di Noia, 2003). The model proposes three regulators: one focused on market stability across the entire financial sector, another on safety and soundness of those institutions supported by a federal guarantee, and a third on protecting consumers and investors. The market stability regulator would be the Federal Reserve, whose role would be implemented through the traditional channels of monetary policy and liquidity provision to the financial system. In addition, the Federal Reserve would be given new and critically important regulatory powers dealing with the overall financial system and would have access to information about a broad range of intermediaries including insurance firms. It will also have the responsibility regarding OTC derivatives markets, and clearing and settlement functions. It is also contemplated the creation of a Federal Prudential Financial Regulator that would combine all federal bank charters into one charter and would consolidate all federal bank regulators into a single prudential regulator. For increased regulatory efficiency, the Blueprint recommends a federal insurance charter

[7] In particular, the Treasury is asking inputs on a number of "General Issues" about the financial system at large, including whether the current regulatory structure adequately addresses consumer or investor protection and if the eventual creation of a single financial market regulator or otherwise consolidating financial regulation would be advisable. Furthermore, the Treasury wants to discuss in-depth specific issues like the central bank's role in regulatory supervision and setting monetary policy, the deposit insurer's proper level of authority and a greater federal involvement in insurance regulation.

[8] GAO report on Financial Regulation, October 2007 (http://www.gao.gov/new.items/d0832.pdf)

[9] http://www.treas.gov/press/releases/hp476.htm

[10] http://www.ustreas.gov/press/releases/reports/Blueprint.pdf.

and puts oversight of these guaranteed products within the jurisdiction of the Federal Prudential Financial Regulator. This should replace the OCC, the OTC and the FDIC. The Conduct of Business Regulator would have the power and the responsibility to monitor business conduct regulation across all types of financial institutions and entities. Business conduct regulation in this context includes several key aspects of consumer protection such as disclosures, business practices, chartering and licensing of certain types of financial institutions, and rigorous enforcement programs. This agency would assume many of the roles of the CFTC, the SEC, and the different consumer protection and enforcement roles today assigned to insurance and banking regulators.

The EU situation

In the EU, in general, regulation focuses first on banking intermediaries, given their traditional dominant role in the financial sector in continental Europe. Most of the recent changes have been induced in member countries under the pressure of EC directives and of increasing cross-border financial market integration that first stimulated and then followed the 1992 single market program and the adoption of the Euro. However, apart from member countries' implicit commitment to ensure that all financial sectors were adequately regulated and supervised, no European law explicitly deals with the problem of how regulating and supervising financial markets and intermediaries. As a consequence, the current picture in the EU is that of a combination of different regulatory approaches. Moreover, in many member countries there is neither a "pure" regulatory model adopted throughout the national financial system.

The Nordic countries, the UK and more recently Austria, Belgium and Germany, have chosen to delegate financial regulation and supervision to a unique agency, separated by the central bank. This is a coherent and integral application of the "Single-Regulator" supervisory model, based on just one control authority with responsibility over all markets and intermediaries. This authority is concerned with all aspects of regulation, but in particular with microeconomic stability and investor protection. In a few other countries, the traditional "institutional" model seems still in place for the insurance sector. In Luxembourg and Finland, a unique agency is responsible for supervision on banking activities, securities markets and investment funds and firms, but not for insurance. As a matter of fact, contracts involving life insurance and capitalization provide services that are directly tied to investment funds or to stock exchange or other financial indices (unit-linked or index-linked contracts). The inclusion of the life insurance segment would be a welcome change given that the distinctiveness of most schemes of life insurance compared to other financial products has been considerably lessened. A specialized "institutional" supervisor is also widely in place for the securities markets: in countries like Italy, Portugal and Spain, this security supervisor is the responsible for investor protection, while the objective of safeguarding stability is assigned to the central bank; in this case, we may say that we have a partial application of the regulatory model by objective. A full application of the twin-peak model is found in the recent Dutch reform, establishing a single authority for financial market transparency and investor protection, while leaving the supervisory responsibility for microeconomic stability to the central bank. In many countries, banking supervision is one of the functions of the national central bank, but only in a very few cases the central bank is still a "monopolist" in the prudential regulation business (Italy, Portugal and Spain).[11]

There is no point in having a common monetary policy in the Euro area while keeping different financial regulations and supervisory rules in each member country. As a matter of fact, these institutional differences are an important barrier to further financial integration and could as well prove to be an impeding factor to smoother transmission of the single monetary policy. In the field of financial regulation, the principle of minimum harmonization and mutual recognition, which was originally thought to be able to naturally induce over time a convergence of regulatory behavior and more uniform rules, did not work. Moreover, there is a concrete risk that competition in this area will not even generate the more efficient outcome: on one side, there exists an incentive to promote less demanding domestic financial regulations and supervision in order to let the own country become more attractive for running financial business; on the other side, it is not clear who will pay the costs of potential insolvency following excessive risk taking behavior and financial misconduct in a member country. Finally, with increasing international banking activities and a European settlement system in place (Target and the planned Target2 Securities), also the argument that domestic regulators and supervisors have better knowledge and can exercise more efficient control becomes day by day less effective (Prati and Schinasi, 1999). We have already mentioned that there are neither clear tools nor responsibilities assigned to counter and/or manage the risk of financial instability and crisis in Europe (Bruni and de Boissieu, 2000). The Treaty is silent on this topic. The role of lender of last resort will be performed by the ECB only in the case of a widespread liquidity crisis affecting the whole Euro area, as happened in the Summer 2007 and in the Fall 2008. What about a liquidity crisis in a single country? And a solvency crisis? Suppose we face a situation in which a single financial institution located in a member country is in trouble. What kind of intervention, if any, is currently allowed? The ECB will not intervene in favor of a single institution, especially if it is interconnected only domestically. Also because it could always assign some of the responsibility for the crisis to the domestic financial regulator-supervisor. The domestic central bank cannot intervene by providing funds without an explicit authorization by the

[11] This classification follows Di Noia and Di Giorgio (1999) and it is based on observing the composition of the Basle Committee of Banking Supervision. Another possibility, in the EU, would be using the composition of the Committee of European Banking Supervisors (CEBS).

ECB. In this case, it will have to convince the latter that the institution is facing a liquidity and not a solvency crisis, according to the old Bagehot's doctrine, and/or that the risk of potential spread and contagion of the crisis is high. This requires time and resources.

Another aspect which has been brought back to the centre of the debate in the recent crisis is that of deposit insurance. Explicit deposit protection may be designed to achieve different policy targets. However, the two main objectives are consumer protection and macroeconomic stability. Small depositors have to be (preferably partially) insured against losses, as they lack the ability to monitor the banks where they place their money. Furthermore, they have to be provided with a mechanism to quickly recover the funds they are supposed to use for transactions. In addition, given the strong links among banks, due to the working of the payment system and the management of monetary policy, it is necessary to avoid or at least minimize the risk that a bank failure spreads out fears of financial contagion in the system, inducing depositors to withdraw their funds even from safe and solid banks (bank runs). Deposit protection is hence viewed as an essential component in the financial safety net, together with the lending of last resort provided by the central bank, standard banking regulation and supervisory controls.

Deposit protection is however not offered homogeneously to depositors across countries. The currently adopted schemes differ widely with respect to many dimensions. Deposit insurance is surely a function of public interest. But its provision can be assigned either to a public or to a private (or mixed) agency. Participation to the system can be mandatory or voluntary, and financial resources devoted to payouts can be collected via ex-ante contributions or by raising funds only when needed (ex-post). The deposit insurer can be given only the task of reimbursing depositors or can be assigned a broader mandate and participate to information collection, crises management and supervisory activities in the banking sector. Only some categories of deposits can be considered to be insured (or all types), and each deposit account or each depositor can be considered eligible for partial or full payout. In the recent crisis both US and the EU countries decided to raise the limits of coverage: in the US from 100.000 to 250.000 dollars, in Europe going up to 100.000 euro and /or adding explicit State guarantee, as in Germany, UK, Ireland, Italy, Greece.

4. A New Architecture for Financial Market Regulation and Supervision in Europe and US.

The selection of a new regulatory model is not easy. However, as already stated, the old “institutional” model could be considered a good candidate only in a context with rigidly separated financial segments, and where no global players are at stake. This picture does not apply either to Euroland or to the US, where we already observe a high degree of integration in financial markets and intermediaries and where multifunctional groups and conglomerates are rapidly growing. A more efficient way to regulate financial intermediaries, including financial conglomerates, would be the explicit adoption of an approach by objective at a federal level. While this would probably be more natural in the US, we think it could also be applied in the Eurosystem. At the same time, it is likely that the somehow chaotic attribution of regulatory powers in the US, could be considerably improved by deciding to adopt a new regulatory framework explicitly based on precise coordination devices, along some of the rules (or better the supervisory practices) already experimented in Europe.

One should start by stressing that not necessarily harmonization and delegation at a federal level means full centralization. If it is too late to continue with different national (or state) regulators and supervisors, it is probably <u>too early to adopt a central regulator (s) and supervisor (s) at the Euro or US federal level</u>. In fact, not only is the Euro or the Federal zone too large, but still too many different rules exist (commercial codes, company laws, failure procedures, corporate governance) and fiscal policies are not completely harmonized. Also, in most cases, state enforcement might still be desirable. In our opinion, a feasible solution is based on a federal approach to financial regulation and supervision, which could be organized with a structure similar to the one established for monetary policy within the ESCB.

The regulatory and supervisory model by objectives could be the right model. This postulates that all intermediaries and markets be subjected to the control of more than one authority, each single authority being responsible for one objective of regulation regardless of both the legal form of the intermediaries and of the functions or activities they perform. According to this scheme, an authority possibly different from the central bank, which remains in charge for monetary policy and macro-stability, is to watch over prudential regulation and micro-stability of both markets and all intermediaries. This agency is to supervise the stability of the entire financial market and of individual financial intermediaries, by licensing authorizations, controlling professional registers, performing inspections, giving sanctions and managing crises. This authority should cooperate with the central bank in supervising security settlement and payment systems and clearing houses, and in monitoring the use of financial instruments in wholesale markets. An authority responsible for transparency and investor protection should supervise disclosure requirements and the proper behavior of intermediaries and the orderly conduct of trading in all financial intermediation activities performed by banking, securities, and life insurance intermediaries (including discipline and control in the area of transparency in contracts). Moreover, this authority would be assigned powers in the area of misleading advertising by financial intermediaries. Finally, it should control macro-transparency in financial markets (including the discipline of insider trading, takeovers and public offers). A fourth authority should guarantee fair competition, prevent abuses of dominant position and limit dangerous concentrations.

A sketch of this “4-peak” model for financial regulation is provided in Figure 1. This solution seems particularly effective in a highly-integrated market context[12] and in the presence of multifunctional operators, conglomerates and groups operating in a variety of different business sectors: its most attractive feature is that it provides uniform regulation for different entities engaged in the same activities. At the same time, it does no require an excessive proliferation of control units. Compared to the "institutional" or the “single regulator” model, a regulatory framework organized by objectives obviously produces a certain degree of overlaps. It could also lead to a lack of controls, given the ambiguity of specific competencies. Since each intermediary is subject to the control of more than one authority, this model might prove more costly than the single regulator model. The intermediaries might in fact be required to produce several reports relating to supervision, often containing identical or similar information. At the same time, the intermediary may have to justify its actions to a whole set of authorities contemporaneously, although for different reasons. Vice versa, a deficit of controls might occur whenever the exact areas of responsibility are not clearly identifiable in specific cases. Moreover, to be effective and to avoid conflicts of interest among the different objectives, this regulatory model needs a coordination committee composed of the members of the three regulators and the central bank. In practice, however, the differences between the single regulator model and the one by objectives may be smaller. We could view the single regulator model as a 3-peak regulatory model by objective, in which the two objectives of prudential supervision and investor protection are given to a single agency.

The horizontal 3 or 4-peak proposal would be inserted into a vertical structure in Europe, and probably also in the US. As already stressed, whether financial “regulation” in the Euro area would be fully centralized at the European level, in alternative to a harmonized regional architecture, is a challenging issue. Many arguments support the view of centralizing and unifying financial regulation in the Eurosystem (in particular, an integrated supervision in a scenario dominated by conglomerates and characterized by the expansion of electronic communication

[12] In Australia, the Financial Sector Reform Act of 1999 harmonized at the Commonwealth level financial rules and supervision assignments. The Australian Securities and Investments Commission (ASIC) protects investors, depositors and insurance policy holders. It regulates and enforces laws that promote fairness and proper behavior in financial markets and exchanges and of financial firms and advisors. It cooperates with other 3 main regulatory bodies (always at Commonwealth level). The Australian Prudential Regulation Authority (APRA) is responsible for ensuring that financial institutions will honour their commitments. It safeguards the soundness of deposit taking institutions, life and general insurance companies, and other financial firms after having inherited the powers and duties previously given to the central bank and to the Insurance and Superannuation Commission. Monetary policy and systemic stability are assigned to the Reserve Bank of Australia, which is the third institutional member represented in the Council of Financial Regulators, the official site where coordination efforts are pushed and conflicts resolved. Finally, the Australian Competition and Consumer Commission is charged with antitrust powers and responsibilities.

networks, market manipulation and trades on the net). However, the feasibility of a European centralized "supervisory" solution is made less likely by the fact that the Euro area might be too large to be controlled by one (or two) central agency, that many different rules are still in place with respect to commercial codes, company laws, corporate governance schemes, and bankruptcy procedures. The EU directives, when they exist, do only establish a common floor; and even with a single currency and a common monetary policy, fiscal policies and taxation of financial services and other items are heterogeneous among member countries of the European Union. Besides, some form of national enforcement is probably still needed.

Hence, we still endorse our proposal of a European System of Financial Regulators (ESFR), structured like the ESCB and organized according to the regulation by objective model (see Di Giorgio and Di Noia, 2003). The ESFR would harmonize and coordinate financial regulation in member countries, design common principles and guidelines for prudential supervision and set out appropriate disclosure instruments and requirements. It would sponsor the necessary institutional changes at the domestic level, so as to merge and reorganize supervisory and regulatory powers in the financial sector of each member country. At the end of the process, in each country there would be just one national agency responsible for each objective of financial market regulation. This national agency would be part to a process of defining the general strategies and principles of financial regulation. It would be responsible for the national implementation of both the rules and the supervisory duties agreed upon at the Euro level.

In the 4-peak version, this reform calls for establishing two new European Agencies, one responsible for the microeconomic stability ("European Prudential Supervision Authority") and one for transparency in the market, investor protection and disclosure requirements ("European Authority for Market Transparency") of all financial intermediaries. These two central agencies would coordinate the different domestic agencies in each member country. Apart from this vertical form of coordination, cooperation would be also desirable horizontally, at both the European and national levels. This coordination, and resolution of eventual controversies, could be provided by special Commissions for the Supervision of the Financial System (as in the Corrigan Report, see Corrigan 1987) established at the European Commission and at national Treasuries. These commissions would be the natural place for activities involving proposals and consultation concerning measures regarding financial market regulation. No antitrust power would be given to any member of the ESFR, so as to avoid the trade-off between competition on one side and stability and transparency on the other. Moreover, agencies responsible for supervising market competition do already exist at both Euro and domestic levels. It would be wise to transform in a third separate and independent central agency the EU Antitrust DG. This agency would coordinate and promote the harmonized activities of domestic Antitrust agencies. In each member state, the national Antitrust agency would be responsible to safeguard competition in all economic sectors. Our suggested 4-peak model for financial regulation in Europe is sketched in figure 2.

We are aware that our proposed architecture is very ambitious and requires indeed a substantial amount of coordination among the different authorities. An additional and delicate problem is how to make these new agencies independent and accountable, a topic that deserves a separate investigation. Another important obstacle is the institutional and political resistance by existing national bodies whose powers would be diminished by the implementation of the proposal.

We would like to stress that some good example of international cooperation and coordination efforts can already be found in the banking supervision, with the Basle Committee working on a wide range of topics with no formal by-laws, but a very strong leadership. At the EU level, after the Lamfalussy report, three “Level 3 Committees” (CESR, CEBS and CEIOPS, see above) assist the EU Commission in drafting level 2 regulatory measures using “comitology” powers[13]. It is to be underlined that while in all European countries the reforming path opted for either a single regulator or regulation by objective, at the European level the old Institutional approach has been followed with 3 separate committees for banks, securities and insurance (and pension funds). The national supervisory systems would gain both in consistency and effectiveness if all stability, transparency and competition oriented rules were either issued or (better) coordinated by distinct independent agencies at the Euro level.

An application of our proposal for the US is actually contained in the mentioned Blueprint. Compared to Europe, the US framework would be greatly simplified by the elimination of one level of supervisory structures, given that it would not be probably necessary to have local supervisors in each of the 50 states. As a matter of fact, several US Federal agencies have already local branches. These may be re-organized in districts rather than at the state level since it is likely that fewer legal and cultural barriers exist among states. The “4-peak” model would maintain and enhance Fed’s responsibility for macrostability and the payment system. The new Prudential Supervision Agency would consolidate the FDIC, the OCC and the OTS and be endowed with all the prudential supervisory powers of local insurance regulators. The SEC (merged with CFTC and some insurance supervisor) would be given full responsibility for investor protection and market transparency. Antitrust powers would remain as they are. A coordination committee among those agencies and the Treasury should be appropriately designed and staffed.

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[13] Comitology refers to the delegation of implementing powers by the Council to the Commission for the execution of EU legislation: representatives of the member States, acting through Committees called “comitology committees”, assist the Commission in the execution of the implementing powers conferred on it (Wise Men, 2001).

5. Conclusions.

In this paper, we have argued that financial market regulation should be re-designed and harmonized in the EU and the US according to a regulatory model by "objectives". This calls for assigning to a limited number of distinct and independent agencies all supervisory powers and regulatory responsibilities in financial markets and on financial intermediaries, regardless of their functions and legal status. These agencies would be in charge, respectively, of microeconomic stability, investor protection and safeguarding competition in the financial sector. They would cooperate with the central bank for the purpose of guaranteeing macroeconomic stability and financial soundness.

In the Euro area, we favor the establishment of two new European financial regulatory agencies, distinct and independent of the ECB. These agencies would be responsible for coordinating legislation and execution of regulation in financial markets: the first European central agency would be responsible for the microeconomic stability of all intermediaries, while the second for transparency and disclosure requirements. The third objective of guaranteeing competition in financial (and non-financial) markets is already safeguarded by the Antitrust General Direction of the European Commission in addition to domestic agencies. It would be wise to transform the EU Antitrust General Direction in a central and independent European agency. The Antitrust General Direction and the two newly created central agencies would be at the center of three European Systems of Financial Regulators, each one structured similarly and working in connection to the ESCB, thereby requiring active participation of national agencies in member countries. It is essential maintaining both levels of regulation and supervision (European-national) in a federal system.

This proposal would face many difficulties. Even if there was a consensus on the final architecture of a financial market regulation, implementation would have political and institutional obstacles. Changes in the Treaty on the European Union are needed in order to establish new agencies. These can be proposed only in the next intergovernmental conference. Changes in national legislation of each Euro countries would also be required. Providing a satisfactory degree of accountability of the new agencies will be equally challenging. Furthermore, a well functioning and harmonized model of financial regulation and supervision would necessitate the participation of the United Kingdom. If it were not to join the Eurozone, the United Kingdom would have to fully participate into the newly created European System of Financial Regulators.

It is easy to predict strong national, political and institutional opposition to the proposal. Hence, full financial market integration would require a much higher degree of political integration in Europe. However, a movement in favor of a scheme similar to ours is emerging. There is already a semblance of federal system in place on macrostability and competition. As regards investor protection and conduct of business, the new Committees created after the Lamfalussy report (CESR and ESC) started to coordinate and guide the national securities regulators. The challenge is to establish prudential supervision and microstability for all financial intermediaries (as CEBS and CEIOPS started to work only recently). Given the consolidated experience of the Basle Committee on Banking Supervision and the recent positive experience of the ESC and CESR, it seems plausible that a new framework for financial market regulation and supervision will emerge in Europe, one based on harmonized regulation at European level and national supervision. As regards the US, the application of our scheme, along the lines contained in the Blueprint, would lead to a strong simplification and would enhance cooperation among regulators.

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Table 1: Current Assignment of Responsibilities for Supervision in Banking, Securities and Insurance Markets in the EU and US

Country	**Banking**	**Securities**	**Insurance and pension funds**
Belgium	U	U	U
Denmark	U	U	U
Germany	U	U	U
Greece	CB	S	G
Ireland	U (CB)	U (CB)	U (CB)
Italy	CB	CB, S	I/FP
Luxembourg	U	U	U/FP
France	CB,B	B,S	I
Spain	CB	CB,S	G
Netherlands	CB,S	CB,S	CB,S
Portugal	CB	CB,S	I
Austria	U	U	U
Finland	BS	BS	I
Sweden	U	U	U
United Kingdom	U	U	U/FP
USA	CB, B	S,S	I

Sources: Updated from Di Giorgio and Di Noia (2003).

Legenda: CB: Central Bank, BS: banking and securities supervisor, B: banking supervisor, S: securities supervisor, I: insurance supervisor, G: government department, U: single financial supervisor.

Figure 1. A 4-Peak Regulatory Model by "Objectives" for the Financial Sector

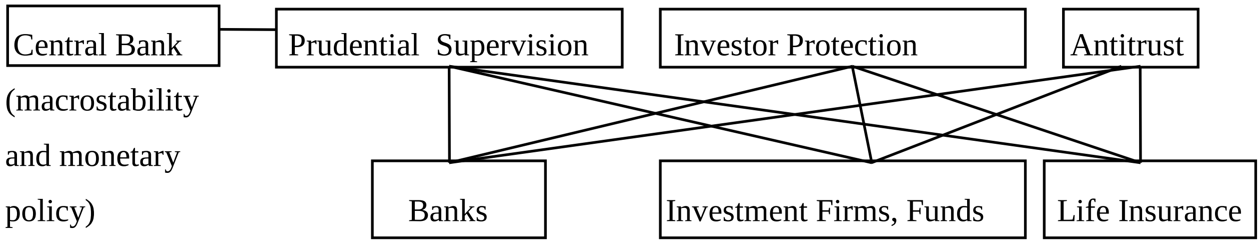

Figure 3. A 4-Peak Regulatory Model by "Objectives" for the Financial Sector in USA