The role of Local and Regional Authorities in the new architecture of the supervision and regulation systems for banks, insurance companies and financial services

The report was written by
the Centre for Strategy and Evaluation Services (CSES).
It does not represent the official views of the Committee of the Regions.

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Catalogue number: QG-32-12-512-EN-N
ISBN: 978-92-895-0638-0
DOI: 10.2863/63364

Table of Contents

Introduction

Aim of the document

The recent global financial crisis has highlighted weaknesses in the current EU supervisory framework, which remains strongly divided along national lines despite greater interconnectedness between national financial markets and the growing importance of cross-border entities. The crisis has prompted renewed calls at both European and Member State levels for further harmonisation in the regulation and monitoring of both financial markets and institutions. In this context, the European Commission appointed the de Larosière High-Level Group (the de Larosière Group) to devise a strategy for harmonising the EU financial regulatory framework.

In its final report, presented on 25 February 2009, the de Larosière Group recommended, among other things, the establishment of an EU-level body charged with overseeing risk in the financial system as a whole through the combination of macro-prudential and micro-prudential supervision.

In a Communication addressing European Financial Supervision published on 27 May 2009[1], the European Commission's DG Internal Market and Services (DG MARKT) set out a series of reforms to the current arrangements for safeguarding financial stability at EU level, including notably the creation of a European Systemic Risk Board (ESRB) responsible for macro-prudential oversight. The Council on 9 June 2009 and the European Council at its meeting of 18 and 19 June supported the view of the Commission and welcomed the Commission's intention to bring forward legislative proposals so that the new framework is in place in the course of 2010.

The aim of this report is to provide information for those local and regional authorities who have expertise in the field of financial services in order for them to influence the creation and effective functioning of a new system for supervising financial institutions. Another aim of this report is to determine how local and regional authorities would benefit from this proposed new supervisory framework so as to improve their knowledge of the financial sector.

[1] COM (2009)252 final.

1. Contextual background

It is widely acknowledged that the 2008-2009 financial crisis was the consequence of factors including persistent global imbalances and rapid credit expansion in the context of low inflation and high growth. The financial services supervisory regime allowed a large increase in levels of financial leverage, a decline in capital adequacy ratios, and under-pricing of risk and a consequent divergence of asset prices from fundamental values. Both macro and micro economic factors caused market excesses and the emergence of systemic risks of unprecedented magnitude and complexity[2]. These factors and processes affected both the overall macro-economic and financial environment as well as the behaviour of individual financial institutions and the functioning of specific market segments.

In the view of the de Larosière Group, the growing interconnectedness of financial markets in Europe has also meant a blurring of the boundaries between different financial activities and across national borders. For instance, banks are increasingly involved in securities markets, and, through the securitisation market, insurance companies have started to invest in banking assets. Over the years, the focus of prudential supervision has been at the micro-level with supervisors assessing the balance sheets of individual financial institutions. However, if micro-prudential regulation examines the responses of an individual bank to exogenous risks, it does not incorporate endogenous risk, and it neglects the systemic implications of common behaviours by market participants. A system that regulates institutions according to their legal status is therefore likely to treat the same activity in different ways, which could result in wasteful regulatory activity.

On the other hand, macro-prudential analysis and supervision focus on the monitoring and assessment of systemic risk across the whole financial sector. This risk, which can emerge both during upswings and downswings during economic and financial cycles, reflects the effects of macroeconomic forces and the collective behaviour of institutions and other market participants[3].

Commission Communication 2009/499 recognises the need for arrangements to be put in place that properly acknowledge the interdependence between micro and macro prudential risks so as to give all stakeholders sufficient confidence to engage in cross-border financial activities. This broader perspective is properly

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[2]Speech by Lucas Papademos, Vice President of the ECB at the conference on “After the Storm: The Future Face of Europe’s Financial System” organised by Bruegel, the National Bank of Belgium and the International Monetary Fund, Brussels, 24 March 2009.
[3] Ibid.

the responsibility of macro-prudential supervisors. The task of macro-prudential supervision is to monitor and assess potential financial-stability risks arising from developments that can impact at a sectoral level or at the level of the financial system as a whole. By addressing such risks, the ESRB would be an essential building block for an integrated EU supervisory structure necessary to promote timely and consistent policy responses among the Member States, thus preventing diverging approaches and so improve the functioning of the Internal Market. This integrated supervision also allows for activities to be monitored on functional, rather than institutional lines in a context where financial institutions are diversifying their services. As such, integrated supervision is a response to the blurring of boundaries between different financial activities.

The Commission considered that since an effective macro-prudential oversight of the Community's financial system cannot be sufficiently achieved by individual Member States because of the integration of the European financial markets, the measures recommended by the Commission are based in accordance with the principle of subsidiarity, as set out in Article 5 of the Treaty establishing the European Community. Similarly, in accordance with the principle of proportionality, the proposed solutions do not go beyond what is necessary to achieve those objectives.

At the same time, a further integrated financial supervisory structure for the EU would require the involvement of all levels of governance. There is therefore a need to define the role of key stakeholders at different governance levels – including local and regional authorities - in this new structure.

2. Financial services industry

The EU financial services industry can be considered as having three main segments:

- **Banking**
- **Securities**
- **Insurance and pensions**

The banking market can be subdivided into

- **Wholesale banks:** providing services to large corporate clients, mid-sized companies, real estate developers and investors, and government entities involving high-value transactions.

- **Retail banks:** offering services to individual customers such as personal loans, savings accounts, and mortgages.

- **Investment banks:** helping private companies and state institutions to raise capital through underwriting, the issuance of securities, and mergers & acquisitions.

While there has been a positive evolution in terms of the extent to which EU financial markets are integrated, national-specific differences exist depending on the market segment, and these are largely correlated with the degree of integration of the underlying financial infrastructures in each segment[4].

The **secured money market segment** (e.g., private repurchase agreements, treasury bills, commercial paper and certificates of deposit, which involve the exchange of liquidity for collateral) remain considerably less integrated due to national differences in market practices, regulations and tax treatments. These national differences are reflected in segmented national-based market infrastructures and can create important practical difficulties in cross-border clearing and settlement.

Conversely, the degree of integration and interconnectedness on the **unsecured money market segment** (i.e. inter-bank deposits) is high, which is principally due to the Euro. There is indeed practically full convergence in very short-term interest rates across the Euro zone. Interest rate convergence has also been helped by the efficient distribution of liquidity across the Euro zone as cross-

[4]De Larosiere report, Annex III.

border transactions account for a large part (about 60%) of total inter-bank activity of the largest market participants[5].

The introduction of the Euro has integrated the national **bond markets** of the participating Member States, resulting in a substantially more homogenous Euro-denominated bond market. The effects of increased integration are evident in many aspects of market activity. The greater liquidity and depth of the Euro-denominated market has been reflected in higher issuance volumes. Additionally, the increased homogeneity of the Euro zone government bond market can be seen through highly convergent yields across the Member States. Outside the Euro zone, the convergence of inflation expectations and other macroeconomic indicators has also resulted in greater integration on the EU bond market.

The integration in EU **equity markets** has also increased mainly in a more sectoral-oriented movement in equity prices across the various Member State markets. Though a national bias still remains in equity holding, institutional investors' behaviour has changed away from country-based investments towards sector-based investments.

The impact of financial integration on the EU banking sector as a whole has also gradually extended to the activities of financial intermediaries. The market for corporate finance services in Europe is increasingly open to global competition. The most visible response of financial intermediaries to the competition intensified by the introduction of the euro has been consolidation which has been accompanied by a restructuring process and a reorientation of activities from 'traditional' bank lending towards 'investment banking' activities. In the context of the cross-border consolidation of stock exchanges, concentration of the underlying financial infrastructures is increasing (i.e. the market share of the five largest stock exchanges in Europe exceeded 90% in 2006)[6].

This reorientation in banks' activities has increased financial market intermediation by creating and selling new capital market products or advising clients on the pricing and structuring of a merger or acquisition. As a result, there has been a shift in bank revenue flows from interest income to non-interest income (i.e. fees and commissions), and reduced reliance on deposits in favour of securities issuance.

The banking and insurance markets are dominated by pan-European financial groups, whose risk management functions are centralised in the groups'

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[5]Carre H. (2006) 'Financial Integration in the European Union', DG Economic and Financial Affairs public document.
[6]De Larosiere Report Annex III.

headquarters. Market trends have revealed an increase in cross-border M&A transactions in terms of value since 2003. This trend was particularly strong in 2005, when several large-value transactions were conducted, amounting to over 50% of the total M&A value in the Euro zone banking system.

However, in spite of this evolution, retail banking activities across the EU remain largely national and fragmented. Several regulatory and environmental factors can explain this fragmentation, such as the role of the State, tax regulations and the financial behaviours of households and small undertakings.

At the regional level, major socio-economic differences can be discerned at a territorial level both in some regions in the former EU15 Member States and those in EU12 Member States. These considerable regional and inter-regional differences increase the importance of structural and behavioural factors that lead to the fragmentation of local markets, bringing about the different commercial penetration of some financial instruments and the dominance of particular financial actors rather than others[7]. The level of concentration in the EU banking sector has been gradually increasing. EU banks have become more international than ever, expanding into foreign markets both in Europe and beyond. At the end of 2007, around 76% of EU banking assets was in the hands of 43 banking groups with substantial cross-border activities[8]. Especially in the Central and Eastern European countries, the banking sectors are dominated by foreign, mostly Western European, financial groups. This difference in concentration between Western and Eastern Europe results in Member States having different market situations and, therefore, a different influence and bargaining power on the market exercised by the national financial operators[9].

Insurance markets have differing characteristics across the EU which can be related to the degree of state pension and healthcare provision (life insurance market) in each Member State, as well as car and home ownership rates (non-life insurance market). Western European insurance markets are increasingly consolidating through mergers and acquisitions. Conversely, insurance markets in Eastern Europe are liberalising and opening up to new entrants.

In Western Europe, consolidation has eased the pressure of competition on the markets. It is also a way for insurance groups to ensure that they are well capitalised. In Eastern Europe, the gradual liberalisation of the economy and

[7]Report on the Retail Banking Sector Inquiry (Final Report), European Commission Communication COM(2007) 33 final.
[8]Speech by Lucas Papademos, Vice President of the ECB at the conference on “After the Storm: The Future Face of Europe’s Financial System” organised by Bruegel, the National Bank of Belgium and the International Monetary Fund, Brussels, 24 March 2009.
[9]De Larosiere report Annex III.

state systems has resulted in a higher degree of penetration from Western European private insurers.

The number of insurance companies has been declining steadily over the last decade, reflecting the wave of mergers and acquisitions that took place at the end of the 1990s.

Since the end of the financial crisis, EU Regulators have sought to impose greater price and risk management discipline through Solvency II, requiring insurers to match their capital more accurately with the risk on their books.

As the insurance industry is one of the largest institutional investors, the fall in stock markets and the put insurers' investment portfolios under pressure at the start of the financial crisis. The evolution of the total investment portfolio is mainly driven by the life insurance sector. The largest component of European insurers' investment portfolio is debt securities and other fixed income assets, followed by shares and other variable assets. The principal aim of insurers when investing in assets is to cover their commitments to policyholders. Insurers generally invest in products with well-defined cash flows and risk profiles and largely limit the risk profile and leverage of their investments so that it is in line with the profile of their liabilities. This makes insurers less exposed than banks to fluctuations in financial markets[10].

In the life insurance market, the impact of the financial crisis has been quite significant, with term-life and unit-linked products hardest hit. Total European life premiums recorded a drop of 11% in nominal terms and at constant exchange rates in 2008, amounting to €644bn compared with €766bn in 2007. On the other hand, non-life insurance premiums have generally been little affected by the economic downturn except for a small number of lines of business, such as credit insurance, that have strong links to economic activity[11].

[10]CEA Annual Report 2008-2009.
[11]European Insurance in figures, CEA Statistics No.37, October 2009.

3. The current regulatory framework

The current European legal framework for financial supervision is based on the activities of three EU-level committees and reflects the structure of the European market.

- **The Committee of European Banking Supervisors (CEBS):** promotes convergence and cooperation of supervisory practices across the EU banking sector through the development of recommendations; provides analyses and performs assessments of risks on the banking sector.

- **The Committee of European Insurance and Occupational Pensions (CEIOPS):** advises the Commission on the preparation of draft implementing measures in the fields of insurance and occupational pensions; issues guidelines to enhance effective implementation of EU directives and the level of cooperation between national supervisors.

- **The Committee of European Securities Regulators (CESR):** develops work mechanisms to enhance consistent supervision in the field of securities; advises the Commission in the preparation of directives relating to securities; monitors timely implementation of EU legislation in the Member States.

These three committees concentrate on coordination of micro-prudential supervision (i.e. supervision of individual financial institutions) and have advisory powers in their relations with the Commission. They mainly aim to foster convergence of supervisory practices across the EU. Generally, the committees' role is one of coordination, and legal enforcement is carried out at national level.

This supervisory framework has its origins in the Lamfalussy process[12] which was designed to make EU legislation on securities markets more flexible so that it can be agreed and adapted more quickly in response to innovation and technological change in financial markets, and for the EU institutions to benefit from the technical and regulatory expertise of European securities regulators and from better involvement of external stakeholders[13]. While the Lamfalussy process originally focused on the securities markets, the Commission later recommended that this process be extended to the other parts of the financial services sector (i.e. banking and insurance). Thus, in March, 2005, the Council

[12]Cf. Lamfalussy Report (15 February 2001).
[13]'The application of the Lamfalussy Process to EU securities market legislation', Commission Staff working document, SEC (2004) 1459.

and the European Parliament adopted a Directive that applies the Lamfalussy process to those two sectors[14].

The Lamfalussy process has also provided a significant impetus in delivering legislation aimed for the EU financial sector. Amongst the more important legal instruments are the following:

The **Markets in Financial Instruments Directive (MiFID)**[15] is the most important piece of EU legislation introduced under the Lamfalussy process. It was designed to cope with, and to further enable, the increased level of cross-border investment transactions, which has become prominent since the late 1990s. It widens the list of financial instruments which are subject to its regulation (e.g. commodities derivatives).

The rationale of the MiFID is to produce greater European harmonisation of laws covering all types of transaction and encourage capital market integration in the EU. The MiFID updates the 1993 Investment Services Directive (ISD).

The MiFID reverses the 'host state rule' established under the ISD as it does not provide any significant role for the host competent authority in the authorisation process for cross-border financial institutions to operate. In other words, any cross-border operation through a branch outside the territory of the Member State in which this branch is located is a provision of services by the investment firm and not by the branch as a separate legal entity. Thus, a company, whether offering services in another Member State through a branch or cross-border, may follow the rules of the 'home state' in which its headquarters are based[16].

The **Solvency II Directive** was designed for the European insurance sector with reference to the Lamfalussy process. This directive introduces a comprehensive system for risk management for defining required capital levels and to implement procedures to identify, measure, and manage risk levels.

The main steps of the Solvency II Directive include[17]:

- **Demonstrating adequate Financial Resources:** applies to all insurance firms and considers key quantitative requirements, including own funds, technical provisions and calculation of the Solvency II capital requirements (the Solvency Capital Requirement - SCR, and Minimum Capital Requirement - MCR).

[14]Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 establishing a new organisational structure for financial services committees.
[15]EU Directive 2004/39/EC.
[16]'Supervision of branches under MiFID', DG MARKT internal document (2007).
[17]http://www.fsa.gov.uk/pages/About/What/International/solvency/index.shtml.

- **Demonstrating an adequate System of Governance:** including effective risk management system and prospective risk identification through the Own Risk and Solvency Assessment (ORSA).

- **Supervisory Review Process:** the overall process conducted by the supervisory authority in reviewing insurance and reinsurance undertakings, ensuring compliance with the Directive requirements and identifying those with financial or organisational weaknesses susceptible to producing higher risks to policyholders.

- **Public Disclosure and Regulatory Reporting Requirements.**

Solvency II is principally based on economic principles for the measurement of assets and liabilities. The rationale for this legislation is to facilitate the development of a Single Market in insurance services in Europe, whilst at the same time securing an adequate level of consumer protection.

Insurance companies are supervised according to the provisions of the **Insurance Groups Directive**[18]. This directive introduces arrangements for the regulatory supervision of insurance and reinsurance undertakings within a financial group. It established the Insurance Groups Supervision Committee, which is tasked with ensuring the monitoring of insurance groups under the Solvency II framework.

The Solvency II directive also bears similarities to the **Basel II Accord**, which establishes an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

Basel II applies to all banks in the EU, regardless of size, mainly in relation to standardised and intermediate approaches for credit and operational risk. The Basel II Accord was transposed into EU legislation through the **Capital Requirements Directive (CRD)**. The CRD is supplemented by other prudential rules developed at national level.

[18] Directive 2009/138/EC.

This legislative framework is based on two pillars:

- **Pillar 1** is based on many of the economic capital practices of banks. It brings minimum regulatory capital closer to the capital generated by banks' internal models. By providing a consistent framework for banks to calculate minimum regulatory capital, supervisors will be better able to identify portfolios and banks where capital is not commensurate with inherent risk levels. It also gives a more conceptually consistent and transparent framework for evaluating systemic risk in the banking system through the credit cycle.

- **Pillar 2** gives regulators the tools to monitor how proprietary risk measurement and management models compare with current practices at micro-level. It also helps firms to improve their internal risk governance by better capital management.

The rationale of the CRD, in line with that of Basel II, is to foster a more coherent relationship between how supervisors assess regulatory capital and how they supervise banks. However, its full effects are not yet known and its implementation is still ongoing.

The global and interrelated nature of the banking sector, banks' importance for financial systems and economies, and the need for consistency and predictability to maintain competitiveness raises many home/host issues and still broader policy questions which pose a challenge for the current policy framework in the context of an EU-wide financial crisis. The emergence of an increasingly integrated financial market in the EU is indeed a major challenge for financial supervision. Indeed, integration increases contagion risks, and thereby jeopardises financial stability. Increased financial integration makes it more difficult to ensure a level playing field in domains where rules and supervisory practices differ. Integration means the development of large cross-border groups, which require more streamlined and cost-effective supervisory organisation at all levels of governance[19].

[19] De Larosiere report Annex III.

4. The proposed new EU financial supervisory framework

At present, the supervision of EU financial infrastructures remains largely based on domestic state supervision. However, where cross-border firms have set up subsidiaries under local law these subsidiaries are regulated finally at the level of the host Member State. Cross-border branches of firms are regulated by the home country, but safeguards have been provided in EU law for host state supervisors to act for example in emergency situations to protect depositors[20]. In the case of investment services, host state supervisors have significant areas of control, such as the right to examine branch arrangements[21]. Host supervisors also retain control of liquidity in branches and require to be informed of all relevant information about the group[22].

The De Larosière report has however pointed out that there are insufficient mechanisms allowing for real and effective collaboration between home country and host country supervisors. Indeed, the report finds that host supervisors do not have comprehensive means to challenge the home state supervision of a financial group which has branching activities in its territories. Furthermore, there is no binding mediation mechanism arbitrating between home and host supervisors, whether for banks, insurance companies or investment firms. In a scenario where a national supervisor fails to take a necessary measure, there is no quick mechanism allowing for a collaborative decision to be taken in relation, for example, to the liquidity or solvency position of a group. The report also concludes that, given such circumstances, there is a lack of effective cross-border crisis management arrangements.

The Commission's proposals for a new EU architecture of the supervision and regulation systems for banks, insurance companies and financial services were based on the recommendations of the De Larosière high-level group.

[20]Article 33, Capital Requirements Directive 2006/49/EC.
[21]Article 32, Directive 2004/39/EC (MiFID).
[22]Article 42, Capital Requirements Directive 2006/49/EC.

This new supervisory framework would imply the creation of two new EU-level monitoring bodies providing the link between macro-prudential and micro-prudential supervision:[23]

- **The European Systemic Risk Board (ESRB)** would be responsible for macro-prudential oversight of the financial system within the EU in order to prevent or mitigate systemic risks, to avoid episodes of widespread financial distress, contribute to a smooth functioning of the Internal Market and ensure a sustainable contribution of the financial sector to economic growth.

- **The European System of Financial Supervisors (ESFS)** is a decentralised system consisting of a network of national financial supervisors, working in partnership with new European Supervisory Authorities (ESAs)[24], is built on shared and mutually reinforcing responsibilities, combining nationally based supervision of firms with specific tasks at the European level. The ESFS would also foster harmonised rules and coherent supervisory practice and enforcement. In terms of macro-prudential supervision, the ESFS is meant to be a decentralised supervisory system that recognises the role of LRAs for day-to-day supervision.

The new framework put forward by the De Larosière group underlines the importance of macro-economic factors and the need for supervisors to monitor them closely. It therefore emphasises better collaboration between supervisors but also a shift of power away from the national level to the regional.

Under the new framework, EU bodies would be given a more decisive role and more power would be handed to supervisory colleges at the expense of single national supervisors.

The interconnectedness of financial institutions implies that the monitoring of systemic risks should rely on a broad set of indicators: economic and monetary analyses from national central banks may not suffice – further development is needed to assess risks across all markets and this could be provided by LRAs (e.g. common credit exposures of interconnected financial institutions to regions).

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[23]COM (2009) 503 final.
[24]I.e. European Banking Authority (EBA); European Securities and Markets Authority (ESMA); European Insurance and Occupational Pensions Authority (EIOPA).

Such changes would effectively give more power to authorities regionally, however the big issue is whether individual countries will countenance surrendering some of their supervisory sovereignty[25].

The new proposals also encourage the implementation of Solvency II to be accelerated as research has pointed out that many small-sized insurance companies were not being supervised adequately and coherently by the Insurance Group Supervision Committee and also that with 40% of insurance groups being part of a financial conglomerate, the Insurance Group Supervision Committee should improve its cooperation with other financial sector supervisors[26].

ANNEX V of the De Larosière group suggested an indicative allocation of competences between national supervisors and the Authorities in the ESFS. It also recommended that certain tasks be undertaken at global level. It did not see a role for local and regional authorities in the supervision of banks. However, that does not mean that local and regional authorities should have no interest in the subject. Local and regional authorities are both involved in providing financial services, and have an interest in the efficient operation of the financial services markets in their areas.

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[25] 'The future of European insurance supervision', Price Waterhouse Coopers study, 2009.
[26] Ibid.

5. Local and Regional Authorities in the financial market

This section considers the role of local and regional authorities in the financial services market. Apart from their general economic importance (local and regional authorities are responsible for nearly one-third of public expenditure and more than two-thirds of public investment in the EU[27]) local and regional authorities are involved directly in the financial services market.

5.1 Regional savings banks

Savings banks in many Member States are firmly rooted in the regions: they are in direct proximity to local people and businesses and contribute to promoting economic, social and territorial cohesion. They play an especially important role in providing the necessary access to finance for business start-ups and small and medium-sized companies (SMEs)[28].

Savings banks play therefore an important role in the development of local and regional economies by financing or co-financing economic projects, in cooperation with businesses and local authorities and by offering access to modern and performing financial services.

For instance, in Germany, savings banks are an important pillar of the banking system. The savings banks are public institutions owned by the regional authorities of the areas they serve. Although they are technically owned by local authorities, they are in fact semi-independent as the local authority has no financial participation in its savings bank. In other words, the regional authority acts only as a guarantor, it does not collect dividends from the bank. Nevertheless, no savings bank can operate outside of its own region. This means that for a savings bank to grow in size, the region must grow economically. This, in turn, fosters intense competition on this segment of the German banking system. Such arrangements also exist in other EU Member States.

A recent inquiry pointed out that in certain local markets concentration ratios are considerably lower than national averages. This could be explained by the importance of local branch networks and could suggest that in some instances

[27] Opinion of the Committee of the Regions on The European Economic Recovery Plan and the role of Local and Regional Authorities, 21-22 April 2009.
[28] Resolution of the Committee of the Regions on the financial crisis (2009/C 76/13).

analysis of competition conditions would more appropriately be conducted on a regional, rather than national, basis.[29]

Across the EU, regional savings banks are local and regional authorities' natural economic partners. Many infrastructure projects throughout the EU have been financed partially or wholly by savings banks. A good example of European savings banks' full commitment to regional development is the FIN-URB-ACT. This European Network project, launched in 2008 and involving 11 cities across the EU, aims to reunite local SME support networks consisting of the cities and local authorities, the local saving bank and other local actors, such as chambers of industry and commerce or development agencies. FIN-URB-ACT seeks to strengthen the performance of the urban economy and to foster employment by providing adequate support structures for innovative, competitive and qualified entrepreneurship. The savings banks of the cities concerned are involved in the FIN-URB-ACT project because of the responsibility and commitment they feel towards their local city and region.[30]

European savings banks are privileged partners for LRAs. They play an important role in providing access to credit to micro and small-sized companies and in putting in place social financial schemes that specifically target individuals at risk of financial exclusion in their regions. They are also amongst the most important sponsors of social, cultural and sports infrastructure at local level.

On their role towards micro and small enterprises, savings banks act as microcredit providers, i.e. easily accessible small-scale loans to local entrepreneurs. Thanks to their proximity, savings banks are close partners of these businesses, providing not only a full range of financial services (credit, savings, payments and insurance) but also dedicated business support services to accompany the enterprise in its development or possible expansion.

For instance, the *Caisse d'Epargne* in France launched a prevention of banking exclusion programme called "*Parcours Confiance*" in mid 2006, targeting customers experiencing social and financial difficulties which were preventing them from finding adapted solutions in other institutions. At the end of 2006, the *Parcours Confiance* was available from 11 local savings banks and almost 350 micro-entrepreneurs had been in contact with the *Parcours Confiance* and about 125 micro-credits had been distributed[31].

[29] 'Financial Services Sector Inquiry, Interim Report – Retail Banking', EFTA Surveillance Authority working paper, 2007.
[30] http://urbact.eu/en/projects/human-capital-entrepreneurship/fin-urb-act/our-project/.
[31] 'Microcredit in Europe - Experiences of Savings Banks', European Savings Banks Group (ESBG) study, 2007.

As mentioned earlier, German savings banks are an important provider of microfinance. Nearly 75% of SMEs have a banking relationship with a member institution of the Sparkassen-Finanzgruppe and almost 60% of SMEs have their local savings bank as main banking partner. In 2006 the German savings banks granted new loans to SMEs amounting to a total of almost 40 billion Euros. The Sparkassen-Finanzgruppe is also an important financial partner providing support to young entrepreneurs: one in two start-ups in Germany are supported by a savings bank. As a practical example, the microfinance operations of the Sächsische Aufbaubank, which works in close cooperation with the Saxon regional government, have helped nearly 500 regional enterprises with a total expenditure of about €7 million between 2006 and 2007. The clients for this programme were start-ups which lacked business experience, with 58% of approvals being to people coming out of unemployment.

Micro-credits are also provided by regional savings banks to vulnerable local communities at risk of financial exclusion. For instance, savings banks in Spain have a long tradition targeting financially under-served communities. In addition to providing funds to promote social community development, around 20 Spanish savings banks have undertaken micro lending activities in their respective region. From 2001 to 2006, they allocated 97.2 million Euros in micro-credits. Statistics have shown that the majority of microcredit clients are migrants[32].

Microcredit organisations involving LRAs also exist in a number of EU Member States. For example, the '*Association pour le Droit à l'Initiative Economique*' (ADIE) in France was created 20 years ago to give financially excluded individuals the opportunity to be reintegrated into the economic system by becoming wealth creators rather than the recipients of state benefits. By working to change the policy environment, while developing a lean delivery model, ADIE has managed to grow rapidly. As of 2007, it had 22 regional offices and 119 local branches across France. At national level ADIE has used its experience to campaign successfully for changes in the regulations so that, for example, a lending 'window' has been established for microfinance, where previously only banks could lend funds that were not their own. At European level it has been behind the establishment of the European Microfinance Network (EMN), an umbrella body for the new industry of microfinance in Europe[33].

Similarly, the *Deutsches Mikrofinanz Institut* (DMI) has been able to bring microfinance into the mainstream, notably through the development of regional and local action plans for microfinance sector development.

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[32] Ibid.
[33] 'Migrating out of the informal economy', EQUAL Community Initiative information paper, 2007.

Through their partnerships with LRAs, European savings banks are therefore contributing actively to reach a higher level of financial inclusion in Europe.

Nowadays, most EU regional savings banks are decentralised and possess branches in other regions or countries. Nevertheless, they maintain close ties with their home regions by supporting financially their economic development.

With regard to cross-border acquisitions between regional financial entities, several linkages between geographical regions can be distinguished across the EU but domestic concentration remains prominent. The two largest cross-border regional clusters in the EU are Scandinavia and the Benelux. These stand out clearly by the magnitude of bilateral flows between the countries included in the cluster, especially the Nordic Countries where intra-regional acquisition deals represent 90% of the deals involving at least one Scandinavian financial entity. This ratio is around 60% for the Benelux region. Within the EU15, intra-regional flows appear to be primarily attributable to geographical proximity. Whereas geographical proximity may also be an explanation for the Scandinavian entry into the Baltic States, this does not apply completely to Member States in Central Europe. For instance, Benelux countries account for around 25% of acquisitions in those Member States. This may be explained by the relative maturity and concentration of the Benelux markets, which drive the institutions to look for new business opportunities in areas with high growth potential[34].

5.2 Economic development support

Apart from granting public funds, LRAs possess a number of financial instruments to stimulate economic activity and have been seeking involvement in a wider range of financial services.

Regional authorities can initiate venture capital schemes to make public funds available for growing SMEs as part of wider regional development programmes generally aiming to stimulate competitiveness and job creation. These schemes can include loans, the provision of equity-based venture capital, guarantees and other instruments. The objective of regional venture capital schemes is to close the 'equity gap' given that equity is an important component of the financing of SMEs.

[34] 'Cross-border consolidation in the EU financial sector', Commission Staff working document, SEC (2005) 1398.

With the demand for venture capital being still a highly relevant economic issue, governments in a number of Member States have introduced SME financing programmes that have a clear regional element.

In the UK, for instance, regional venture capital funds (RVCF) were set up in each region to serve SMEs on an almost compulsory basis, being the initial institutional investor. This programme, which started in 2001, was designed to address the equity gap for risk capital available to SMEs. A number of regional venture capital funds were thus created in order to provide risk capital of up to £500,000 to growing SMEs. These funds are operated by professional fund managers. Regional Development Agencies (RDAs) have a crucial role in ensuring the success of RVCF programmes. The role of RDAs is to assist the fund manager in raising the necessary private sector investment by utilising their contacts and knowledge of the business support network within their region. Up to £80 million was initially allocated to the RVCF scheme. The scheme is based on the State's financial contribution being subordinated to the interests of both the limited partners and the management company. The regional component of venture capital helps in the process of regional industrialisation and also contributes to reducing financial uncertainty and minimising investment risk[35].

At EU level, the Joint European Resources for Micro to Medium Enterprises initiative (JEREMIE) launched in 2006 by DG REGIO and the European Investment Bank (EIB), offers regional Managing Authorities of Member States the opportunity to use part of their EU Structural Fund allocation to indirectly finance SMEs, through financial intermediaries, by means of equity, loans or guarantees, through revolving Holding Funds. In accordance with the structural funds regulations, these Holding Funds can be managed either by the EIF (European Investment Fund) or regional authorities. JEREMIE's Equity instruments are implemented mainly through venture capital funds targeting early stage companies. Holding Fund Manager may make investments in selected venture capital funds, generally innovative companies with high growth potential. Priorities regarding stage or sector focus or funds are generally set by the regional Managing Authority. In relation to EU structural funds programmes, the JEREMIE initiative covers all 27 EU Member States and is not restricted to Convergence Objective regions. All regions of both Convergence and Competitiveness Objectives are eligible, provided that Member States or Managing Authorities have identified the potential need for JEREMIE in their respective operational programmes and decide to implement JEREMIE[36].

[35] http://www.berr.gov.uk//whatwedo/enterprise/enterprisesmes/info-business-owners/access-to-finance/regional-venture-capital-funds/page37596.html.

[36] http://www.eif.org/jeremie/activity/j_instruments.htm.

With regard to the financial crisis, the main point of concern for LRAs has been the difficulties in accessing investment resources from loans. Recent evidence shows that a significant proportion of LRAs have asked their national governments to assist them in accessing loan finance through the provision of borrowing guarantees or by relaxing strict legislation concerning public borrowing[37].

[37] 'The Economic and Financial Crisis – Impact on Local and Regional Authorities', Council of European Municipalities and Regions (CEMR) second survey, November 2009.

6. Issues for local and regional authorities

In considering a response to the new regulatory framework, local and regional authorities need to consider their objectives in respect of the financial services industry. The principle of decentralisation is closely linked with the principle of subsidiarity and is applied in areas where tasks are not managed efficiently. The principle of subsidiarity is enforceable not only between the European Union and its Member States, but it is also relevant between national governments and local or regional ones.

Local and regional authorities are at the same time users of financial services and have an interest on behalf of the population of their area in ensuring the efficient supply of services. In some cases they are also involved in the provision of these services.

From a local or regional point of view, considering the demand for financial sevices, authorities might consider that some of their objectives could include:

- An adequate level of provision of financial services in the region, with an appropriate level of competition, so that the needs of consumers and enterprises are met.

- Access by enterprises to capital, so that economic development is facilitated.

- Wide access to financial services to minimise the risk of financial exclusion.

From a supply point of view, local and regional authorities might be concerned that the services they supply or help supply meet the above criteria, and also ensure additionality for the use of public funds.

Summary of recommendations of the de Larosière High-Level Group

Note: the High-level Group made 23 recommendations. These recommendations are summarised below. Many recommendations contained several paragraphs of detailed points and the full text is, of course, in the report.

1. The Group sees the need for a fundamental review of the Basel II rules.

2. In the EU, a common definition of regulatory capital should be adopted, clarifying whether, and if so, which hybrid instruments should be considered as tier 1 capital.

3. A strengthened CESR should be in charge of registering and supervising Credit Rating Agencies.

4. With respect to accounting rules the Group considers that a wider reflection on the mark-to-market principle is needed.

5. The Group considers that the Solvency II directive must be adopted and include a balanced group support regime.

6. Competent authorities in all Member States must have sufficient supervisory powers, including sanctions, to ensure the compliance of financial institutions with the applicable rules and should also be equipped with strong, equivalent and deterrent sanction regimes to counter all types of financial crime.

7. Concerning the "parallel banking system" the Group recommends to extend appropriate regulation, in a proportionate manner, to all firms or entities conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large.

8. Concerning securitised products and derivatives markets, the Group recommends to simplify and standardise over-the-counter derivatives.

9. With respect to investment funds, the Group proposes to further develop common rules for investment funds in the EU, notably concerning definitions, codification of assets and rules for delegation.

10. In order to tackle the current absence of a truly harmonised set of core rules in the EU, the Group recommends that Member States and the

European Parliament should avoid in the future legislation that permits inconsistent transposition and application.

11. In view of the corporate governance failures revealed by the current financial crisis, the Group considers that compensation incentives must be better aligned with shareholder interests and long-term firm-wide profitability.

12. With respect to internal risk management, the Group recommends that the risk management function within financial institutions must be made independent.

13. The Group calls for a coherent and workable regulatory framework for crisis management in the EU.

14. Deposit Guarantee Schemes in the EU should be harmonised and preferably be pre-funded by the private sector.

15. In view of the absence of EU-level mechanisms for financing cross-border crisis resolution efforts, Member States should agree on more detailed criteria for burden sharing.

16. A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logistical support of the ECB.

17. An effective risk warning system shall be put in place under the auspices of the ESRC and of the Economic and Financial Committee (EFC).

18. A European System of Financial Supervisors (ESFS) should be set up. This ESFS should be a decentralised network.

19. In the first stage (2009-2010), national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU.

20. The EU should also develop a more harmonised set of financial regulations, supervisory powers and sanctioning regimes.

21. The Group recommends an immediate step-change in the working of the level 3 committees which can be dealt with at once, (eg by better funding)

22. In the second stage (2011-2012), the EU should establish an integrated European System of Financial Supervision (ESFS).

23. The Group recommends that planning for the 2 stages of the new system be started immediately.

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Acronyms

CEBS:	the Committee of European Banking Supervisors
CEIOPS:	the Committee of European Insurance and Occupational Pensions
CESR:	the Committee of European Securities Regulators
MiFID:	Markets in Financial Instruments Directive
ESRB:	the European Systemic Risk Board
ESFS:	the European System of Financial Supervisors
LRA:	Local and regional authorities