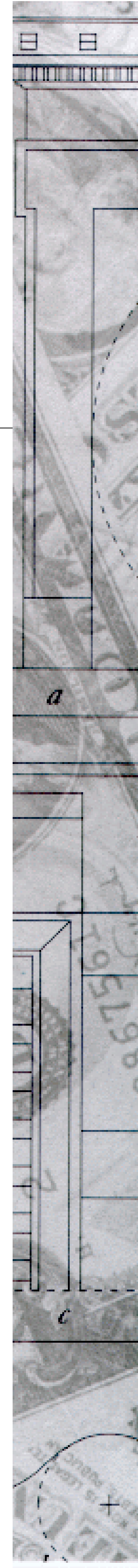
Wharton

Financial Institutions Center

Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area

by
Giorgio Di Giorgio
Carmine Di Noia
and Laura Piatti

00-24



The Wharton School
University of Pennsylvania

The Wharton Financial Institutions Center

The Wharton Financial Institutions Center provides a multi-disciplinary research approach to the problems and opportunities facing the financial services industry in its search for competitive excellence. The Center's research focuses on the issues related to managing risk at the firm level as well as ways to improve productivity and performance.

The Center fosters the development of a community of faculty, visiting scholars and Ph.D. candidates whose research interests complement and support the mission of the Center. The Center works closely with industry executives and practitioners to ensure that its research is informed by the operating realities and competitive demands facing industry participants as they pursue competitive excellence.

Copies of the working papers summarized here are available from the Center. If you would like to learn more about the Center or become a member of our research community, please let us know of your interest.

Anthony M. Santomero
Director

The Working Paper Series is made possible by a generous grant from the Alfred P. Sloan Foundation

FINANCIAL MARKET REGULATION:

THE CASE OF ITALY AND A PROPOSAL FOR THE EURO AREA[§]

by Giorgio Di Giorgio*, Carmine Di Noia** and Laura Piatti***

This Version: June 2000

ABSTRACT

The objective of the present work is to sketch a proposal for the re-organisation of regulatory arrangements and supervisory agencies in the European financial markets. This proposal is formulated in light of the evolution of the role of intermediaries and aims at speeding the ongoing process of integration of financial markets in the Euro area. It is based on previous experiences in the matter of financial regulation at both national and international level.

We start by reviewing objectives and theoretical models for the regulation of financial systems. We then move to highlight some features of financial market regulation in Italy that we consider somehow problematic as a consequence of the recent evolution in the financial intermediaries, instruments and markets. A proposal is then formulated for a new configuration for supervising the domestic financial market through the assignment of different objectives or "finalities" to different authorities. This perspective would thus entrust the three objectives of supervision -- stability, transparency and proper behaviour, competition -- to three distinct authorities designed to oversee the entire financial market regardless of the subjective nature of the intermediaries.

We think that our proposal could be transferred (with some benefit) to the Euro area. This requires to explicitly address what is probably the weakest point and the more evident problem of the European Union construction, that of who takes care of financial stability. In particular, one has to re-examine the issue of the need for a lender of last resort and of the proper relationship of the European Central Bank with other financial market regulators. We propose to establish a European System of Financial Supervisors, with three distinct independent authorities (plus the ECB) at the European level. They will provide incentives for and co-ordinate the work of the three corresponding national authorities in each member country.

§ A previous version of this paper was presented at the 22nd SUERF Colloquium, co-organised with the Oesterreichische Nationalbank and the University of Vienna, and held in Vienna in April 2000. We thank Karel Lannoo, Andy Mullineux and Michael Taylor for useful discussion and comments. The opinions expressed are only those of the authors and do not necessarily coincide with those of the Institutions they are affiliated with. Giorgio Di Giorgio gratefully acknowledges financial support from CNR.

* University of Rome “La Sapienza” and University LUISS Guido Carli, Rome, Italy, Email: gdg@luiss.it
** Consob, Market Division, Rome, Italy, Email: c.dinoia@consob.it
*** Reale Mutua Assicurazioni, Life Insurance and Pension Funds Dept., Turin, Italy, Email: piatti@realemutua.it

Correspondence to: Carmine Di Noia, Divisione Mercati, Consob, Via Mantova 1, Roma 00198 Italy

I. INTRODUCTION

The evolution of financial markets has been particularly significant in the last decades with regard to intermediaries, capital markets and financial instruments. Structural changes have mainly involved the more traditional financial operators in banking, but have also involved investment firms and insurance companies.

Regulatory arrangements have also been the object of significant change. Such dynamics are at the centre of attention at international venues. A number of countries (the United States, the United Kingdom, Australia and Japan) are in fact presently radically changing their regulatory systems[1]. In other European countries, evolutionary trends are moving in the same direction. Moreover, with the start of Phase III of the EMU, the responsibility for monetary policy in the Euro zone has been assigned to the European Central Bank, while banking and financial supervision tasks have been left to domestic agencies. A relevant novelty in Europe is then "the abandonment of the coincidence between the area of jurisdiction of monetary policy and the area of jurisdiction of banking supervision"[2]. The "double separation" (geographical and functional) between central banking and banking supervision, and the absence of any explicit reference to "who takes care of financial stability" in Europe, did cast some doubts about the efficacy of the current regulatory arrangements in preventing and managing financial crisis and are currently at the centre of a lively debate.

The objective of the present work is to set up a proposal for the reorganization of regulatory arrangements and supervisory agencies in financial markets both in Italy and the European Union.

The essay opens with a section investigating objectives and theoretical models for the regulation of the financial system[3].

We then describe recent evolutionary dynamics in financial markets, intermediaries and instruments. We focus first on the Italian situation. Here, we highlight some "anomalies" proper to the current regulatory system. Hence, we present a proposal for a new configuration for supervising the domestic financial market through the assignment of different objectives or "finalities" to different authorities.[4] This perspective would thus entrust the attainment of the three objectives of supervision on the entire financial market -- stability, transparency and investor protection, competition -- to three distinct authorities regardless of the subjective nature of the intermediaries, whether they be in banking, finance or insurance[5]. This scheme would innovate current arrangements

---

[1] Concerning these issues see Coffee, 1995; Dale, 1997; Taylor, 1997.
[2] Padoa Schioppa, 1999.
[3] See also Goodhart and Shoenmaker, 1992; Dewatripont and Tirole, 1994; Merton and Bodie, 1995; White, 1997.
[4] See also Di Noia and Piatti, 1998.
[5] The reference is, in the following, to life-insurance, whose behaviour is very close to the other financial

by delegating to a sole authority the objective of transparency in banking and the suppression of misleading advertising of financial products. In addition, it would highlight the objective of competition (especially in banking) as a distinct finality explicitly monitored by the regulator. Moreover, for the sake of consistency, the existing rules applying to other forms of financial intermediation would be extended to include the life insurance sector.

We then extend our proposal for a regulatory reform in Italy to the Euro area. This requires to explicitly address the problem of who takes care of financial stability in the Euro area. We re-examine the issue of the need for a lender of last resort and of the proper relationship of the European Central Bank with other financial market regulators. We propose to establish a European System of Financial Supervisors, with three distinct independent authorities (plus the ECB) at the European level. These agencies ought to be characterized by homogeneous procedures in terms of their creation, functioning and funding. They will push and coordinate the work of the three corresponding national authorities in each member country.

The paper is organized as follows. In section II we describe the objectives and the motivations for financial markets regulation and we identify four models of regulatory structure. In section III we deal with the regulatory framework currently in place in Italy. We first highlight what we think are its problematic features and anomalies. We then present an hypothesis of reform based on a fully coherent application of the supervisory model by objectives (or by finality). In section IV we argue that such a reform could be extended to the Euro area. Finally, we summarize our conclusions.

II. MODELS FOR FINANCIAL MARKET REGULATION AND SUPERVISION.

II.1 FINANCIAL MARKET REGULATION.

The theoretical underpinning for public intervention in economic matters is traditionally based on the need to correct market imperfections and unfair distribution of the resources. Three more general objectives of public intervention derive thereby: the pursuit of stability, equity in the distribution of resources and the efficient use of those resources.

The regulation of the financial system can be viewed as a particularly important case of public control over the economy. The accumulation of capital and the allocation of financial resources constitute an essential aspect in the process of the economic development of a nation. The peculiarities of financial intermediation and of the operators who perform this function justify the existence of a broader system of controls with respect to other forms of economic activity. Various

intermediaries.

theoretical motivations have been advanced to support the opportunity of a particularly stringent regulation for banks and other financial intermediaries. Such motivations are based on the existence of particular forms of market failure in the credit and financial sectors[6].

The objectives of financial market regulation.

The definition of the term 'financial market' has traditionally included the banking, financial and insurance segments. The bounds 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). In this essay, as the bounds dividing the various types of financial institutions are becoming increasingly blurred (Corrigan, 1987), we shall refer to the financial market as an economic space wherein operators of various kinds -- banks, financial intermediaries, mutual funds, insurance companies, pension funds -- offer financial instruments and services.

A primary objective of financial market regulation is the pursuit of macroeconomic and microeconomic stability. Safeguarding of the stability of the system translates into macrocontrols over the financial exchanges, clearing houses and securities settlement systems. Measures pertaining to the microstability of the intermediaries can be subdivided into two categories: general rules on the stability of all business enterprises and entrepreneurial activities, such as the legally required amount of capital, borrowing limits and integrity requirements; and more specific rules due to the special nature of financial intermediation, such as risk based capital ratios, limits to portfolio investments and the regulation of off-balance activities.

A second objective of financial regulation is transparency in the market and in intermediaries and investor protection. This is linked to the more general objective of equity in the distribution of the available resources and may be mapped into the search for "equity in the distribution of information as a precious good" among operators.[7] At the macro level, transparency rules impose

[6] White (1996) identifies certain categories of "market failure", describing them with special regard for the financial markets: i) situations of market power brought about because of collusion, concentration, technological conditions or public regulatory conditions; ii) economies of scale, as in the case of capital markets where an inverse relation exists between the volume of transactions and the costs of transaction; iii) externality (spillover) effects, as in the case of a bank failure generally affecting the confidence of savers in the entire banking system; iv) public good problems, as in the case of the property of prices formed on the exchanges; v) information asymmetries, typically found among buyers and sellers of financial products; vi) individuals who are unable to know their own best interest, as in the case of forms of savings they are "unacquainted with" present in financial markets.

[7] One of the classic instances of market failure is relative to the presence of information asymmetries. However, some recent theories of financial intermediation (Allen and Santomero, 1997) seem to go beyond theories based on

equal treatment (for example, rules regarding takeovers and public offers) and the correct dissemination of information (insider trading, manipulation and, more generally, the rules dealing with exchanges microstructure and price-discovery mechanisms). At the micro level, such rules aim at non-discrimination in relationships among intermediaries and different customers (conduct of business rules).

A third objective of financial market regulation, linked with the general objective of efficiency, is the safeguarding and promotion of competition in the financial intermediation sector. This requires rules for control over the structure of competition in the markets and, at the micro level, regulations in the matter of concentrations, cartels and abuse of dominant positions.

Specific controls over financial intermediation are justified by the forms that competition can assume in that field. They are related to the promotion of competition as well as to limiting possible destabilizing excesses generated by competition itself.[8]

II.2 FINANCIAL MARKET SUPERVISORY MODELS.

There is neither a unique theoretical model nor just one practical approach to the regulation and supervision of financial markets. Significant differences are found in the literature in terms of both definition and classification of regulatory models and techniques.

We identify four approaches for financial market supervision and regulation: "institutional supervision", "supervision by objectives", "functional supervision" and "single-regulator supervision".

Institutional supervision.

In the more traditional "institutional approach" (also known as "sectional" or "by subjects" or "by markets"), supervision is performed over each single category of financial operator (or over each single segment of the financial market) and is assigned to a distinct agency for the entire complex of activities. In this regulatory model, which follows the traditional segmentation of the financial system into three markets, we thus have three supervisory authorities acting as watchdogs over, respectively, banks, financial intermediaries and mutual funds, and insurance companies (and the

---

information: a look at reality in fact shows that while transaction costs and asymmetric information have greatly decreased, the activity of intermediation has considerably increased. Financial markets seem to be more and more markets for intermediaries than for investors or firms. The nature of all financial intermediaries (not only banks, but also mutual funds, financial intermediaries, financial firms, pension funds) seems to be that of operators who perform risk management activities on behalf of third parties and decrease the "costs of participation" in the financial market: these two aspects have not yet been the object of in-depth analysis by intermediation theorists. These same two motivations are thought to contribute to the building of long-term relationships between intermediaries and customers in such a way that the latter avoid *ex ante* research costs by simply buying the implicit insurance supplied by the intermediaries (Allen and Gale, 1998).

[8] On more than one occasion the European Commission has reaffirmed the applicability to financial markets of the

corresponding markets). The authorities control intermediaries and markets through entry selection processes (e.g., authorizations and enrolling procedures in special registers), constant monitoring of the business activities (controls, inspections and sanctions) and eventual exits from the market (suspensions or removal)[9].

"Institutional" regulation facilitates the effective realization of controls, being performed with regards to subjects that are regulated as to every aspect of their activity and as to all the objectives of regulation. Each intermediary and market has only one supervisory authority as a counterpart. The latter, in turn, is highly specialized. As a result, duplication of controls is avoided and the costs of regulation can be considerably reduced.

The institutional approach seems to be particularly effective in cases of intermediaries of a very similar type and that do operate in just one of the three traditional segments of financial intermediation. Vice versa, the institutional model may give rise, in the presence of more subjects entitled to perform the same financial intermediation activities[10], to distortions in the supervisory activity caused by the enforcement of different dispositions for operations of the same nature that are executed by different entities. The disadvantages of this approach are represented by the previously mentioned trend toward multiple-sector activities and by the progressive de-specialization of the intermediaries. In turn, these phenomena are connected to the growing integration of both markets and instruments, that frequently leads to the building of large financial conglomerates. In a context where the boundaries separating the various institutions are progressively being erased, it is no longer possible to establish whether a particular subject is a bank, a non-banking intermediary or an insurance company; or whether a group is involved more in one or another of such activities. Therefore, there is the risk that "parallel" systems of intermediaries may be created, reflecting the diversity of the respective control authorities. In this case, the way the controls are set up may become a destabilizing rather than stabilizing factor. Moreover, the intermediaries might be induced to choose their juridical status in a way which is contingent on the different rules that discipline different subjects.

A further possible element of weakness in the model lies in the fact that when a single authority supervises a category of subjects and pursues more than one objective, the result of the control activity might not be effective in the event that different objectives are in conflict[11].

---

general regulation on competition. The Court of Justice has also upheld such orientation.

[9] As an example of the institutional approach, one can consider the regulatory system provided for the insurance market and intermediaries in Italy by the Isvap (See below - Section III).

[10] Consider the negotiating activity in the stock exchange performed by both banks and financial intermediaries, or else the gathering of savings realized by life insurance companies, similar to that undertaken by mutual funds.

[11] The classic example is the trade-off between the objective of stability and that of competition (See below - Section

Supervision by objectives.

The supervisory model by objectives (or by finalities) 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 is to watch over both market stability and the solvency of each intermediary, whether in banking, finance or insurance; another authority will be responsible for the transparency of financial markets and will control the behavior of banks, financial intermediaries and insurance companies toward customers; a third authority will guarantee and safeguard competition over the entire financial market and among intermediaries[12].

The basic advantage of this regulatory model lies in the fact that it is particularly effective in a highly-integrated market context and in the presence of polifunctional operators, conglomerates and groups operating in a variety of different business sectors. At the same time, it does not require an excessive proliferation of control units.

The most attractive feature of this scheme is that it provides uniform regulation for the different subjects engaged in the same activities.

Compared to the "institutional" model, a regulatory framework organized by objectives may produce a certain degree of multiplication of the controls. And sometimes it could lead to a lack of certain controls. Indeed, the specific assignment of competencies with respect to the objectives of regulation is not necessarily univocal and all-inclusive in practice. In such a model, each intermediary is subject to the control of more than one authority, and this may be more costly. 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 intermediaries may have to justify the same action to a whole set of authorities contemporaneously, even though for different reasons. Vice versa, a deficit of controls might occur whenever the exact areas of responsibility are not clearly identifiable in specific cases.

Functional Supervision.

The third regulatory model is the so-called "functional supervision", or supervision "by

---

III).

[12] In the Italian system, the supervisory model by objectives has found application, at least nominally, in the Finance Law "Testo Unico delle disposizioni in materia di intermediazione finanziaria" (DL 58/1998) where it is established, with reference to intermediaries, that the competent authority in the matter of risk containment and financial stability is the Banca d'Italia, while the Consob is responsible for transparency and proper behavior.

activity". It considers as "given" the economic functions performed in the financial system; unlike other lines of thought regarding supervisory activities, this approach does not postulate that existing institutions, whether operative[13] or regulatory[14] , must necessarily continue to exist as such, in terms of both their structure and role. The "functions" or activities undertaken are considered to be more stable than the institutions that perform them. Competition among financial systems is thought to drive existing institutions to evolve in a dynamic perspective in the direction of new and more efficient forms.

According to Merton and Bodie (1995), the financial system is considered to perform six basic functions:

- to provide ways of clearing and settling payments in order to facilitate trade;
- to provide a mechanism for the pooling of resources and for portfolio diversification;
- to provide ways of transferring economic resources through time, across borders, and among industries;
- to provide ways of managing risks;
- to provide price information to help coordinate decentralized decision making in the various sectors of the economy;
- to provide ways of dealing with the incentive problems created when one party in a transaction has information that the other party does not have or when one party acts as agent for another.

In the functional supervisory model, each type of such financial services should be regulated by a given authority independently of the operator who offers it. Hence, also this approach has the important advantage that it calls for the same rules to be applied to intermediaries who perform the same activity of financial intermediation even though such operators may fall into different categories from a legal standpoint. For example, activities including investment management, the gathering of deposits, lending, and savings invested in insurance/retirement funds are each subject to homogeneous rules established by individual authorities, which independently supervise such activities regardless of the institutions engaged. This approach fosters economies of specialization within the supervisory authorities and might represent a rather attractive solution for the regulation of integrated, advanced financial markets. However, it is not without drawbacks. This model envisions an overlapping of bodies controlling the same subject: there is the risk of an excessive division of competencies among the regulatory agencies.[15]

[13] Banks, mutual funds, intermediation firms, insurance companies and other financial intermediaries.

[14] Bodies for controlling stability, supervisory organs to guarantee transparency, antitrust authorities and other supervisory agencies.

[15] Oldfield and Santomero (1997) view financial institutions as a set including banks, insurance companies, investment companies (open and closed funds, other forms of collective investment, pension funds), origination firms

A further disadvantage of the functional approach is that finally what is subject to failure is not the activity performed, but the institution. In case of serious problems of stability, it would be essential to guarantee protection and oversight with regard to the institutions rather than to individual operations (Padoa-Schioppa, 1988).

"Single-regulator supervision".

The single-regulator supervisory model is based on just one control authority, separated from the central bank, and with responsibility over all markets and intermediaries regardless of whether in the banking, financial or insurance sector. This authority would be concerned with all the objectives of regulation (stability, transparency and investor protection, maybe competition).

In the regulatory practice, the centralized supervisory model has typically characterized early stages of financial system development, often in periods when the central bank was the only institution that supervised the activity of financial intermediaries. Faced in recent times with the globalization and integration of the markets, the English brought this model back into being with the creation of the Financial Services Authority - FSA (See Briault, 1999).[16] The British executive's decision to merge the preexistent supervisory authorities – part of the Central Bank staff, the Securities Investment Board, the directorship of the Department of Trade and Industry competent in the insurance field and the Security Regulatory Organizations (SROs) -- in the FSA is based on the search for a more efficient organization of regulatory activities including a reduction in the costs of regulation itself. Also, it was considered useful to have just one agency accountable to the Parliament and to the market[17].

The advantages of this approach lie in the economies of scale that it produces. Fixed costs and logistical expenses, the costs of administrative personnel and the compensation for the top management are all considerably reduced. Moreover, this scheme calls for a unified view which is particularly useful and effective with respect to polifunctional groups and conglomerates. By the

---

(investment firms, credit institutions, insurance brokers and financial promoters), market-makers (specialists, dealers and reinsurance companies), stock exchanges (cash and derivatives), clearing houses and other financial operators. The services provided by these financial institutions can be classified in six different activities: origination (identification, evaluation and creation of financial activities originating with the customers of an institution), distribution (the collection of funds through the sale of new financial products), servicing (the management of payments flow from financial activities issuers to holders), packaging (pooling and tailoring of financial activities to fit the specific needs of customers through greater personalization of goods and services offered), intermediating (setting up of financial activities and contemporaneous buy-back of different financial activities on the part of the same intermediary), market making (purchase or sale of financial activities). In a regulatory perspective this taxonomy might lead to an arrangement wherein every activity would correspond to a different supervisory activity.

[16] The single-regulator model was first developed in Scandinavia (Denmark, Norway and Sweden) more than a decade ago. See Taylor and Fleming (1999).

[17] The costs of the FSA are funded directly by the market through a system of contributions and taxes charged to the supervised institutions.

same token, the costs of supervision charged to the subjects regulated and/or to the taxpayer decrease.

However, the validity of this model depends to a high degree on its internal organization: if the numerous areas of competence and specialization are not well-structured and coordinated, the risk is to slow the decision-making process. As underlined by Wilson (1989), what counts is a clear definition of the agency's "mission". Also, the presence of a sole regulator might render collusive relations more immediate and direct (“regulatory capture”). Finally, it might exacerbate problems of self-contradiction in the event that the authority should find itself forced to pursue conflicting supervisory objectives. This sort of problem might in part be overcome thanks to an internal organization divided "by objectives", but the fact that there is only one top management would end up in the prevalence of a single objective as final consequence of the decision-making process.

II.3 IS THERE AN OPTIMAL MODEL FOR SUPERVISION?

Our presentation of the main regulatory models of the financial system should have made clear how hard it is to establish which alternative offers a decisively superior arrangement. In real life we find a prevalence of "mixed" approaches which borrow in heterogeneous fashion elements that are proper to more than just one model.

The 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. Nowadays, we think that this picture does not apply to the major advanced countries, where we do observe high integration in financial markets and intermediaries and a strong presence of polifunctional groups and conglomerates.

The most evident problems with regard to the functional supervisory model are the following: i) it might call for too many regulators, corresponding to the numerous functions and activities that the intermediaries perform; ii) it does not explicitly address questions regarding the stability (possible failures) of the single institutions.

Hence, we think that modern financial systems should rely on either a single regulator or independent agencies, each one responsible for one of the three objectives of regulation.

However, we are particularly concerned with the possible conflict of interest in pursuing different objectives when these are assigned to the same agency. Clearly, the "single-regulator" model is truly affected by the possible incompatibility among the supervisory objectives.[18] In the credit sector, for instance, we find a clear trade-off between competition and stability (at least in the

[18] Moreover, the single- regulator model could also lead to excessive concentration of regulatory powers.

short run). The need to safeguard stability led, particularly in moments of economic and financial tension, to the use of instruments designed to limit competition, such as institutional barriers to entry in the market, or to the legal imposition of limits to operative activities. In financial systems where banks are prevalent but not efficient enough to compete cross-border, the objective of competition is usually sacrificed more easily than that of macroeconomic stability. The consequence is a "stable" environment in terms of the number and identity of the intermediaries. But this is obtained by altering the free play of competition through measures that prevent exit of inefficient actors from the market.

Another case is that of the possible conflict between the objectives of stability and transparency. Again with regard to the banking sector, scarce transparency in fund gathering activities (e.g., in the issue of securities) might allow the application of interest rates below market rates. Such behavior could be considered functional to the strengthening of the stability of banks, but it would result in direct injury to investors.

The most immediate response to this important problem might be to attribute to different authorities different objectives of supervision, that is to adopt the regulatory model by objectives as the benchmark for advanced financial systems. This solution could be designed so as to avoid an excessive proliferation of authorities and thus limit the increase in both direct and indirect costs of regulation[19] . In what follows, we will present a proposal of reform of the regulatory framework currently in place in Italy which is inspired by this model. We will also argue that such model could be usefully adopted at the Euro level.

III. REGULATORY ARRANGEMENTS IN THE ITALIAN FINANCIAL SYSTEM

III.1 INTEGRATION AMONG INTERMEDIARIES, MARKETS AND INSTRUMENTS

As already mentioned, banking, securities and insurance segments are becoming increasingly integrated in terms of markets, intermediaries and financial instruments. The boundaries separating banking, securities and insurance activities are in fact on their way out in most developed financial systems because of the strong process of technological, geographical and functional integration among these three sectors; and as a consequence of the de-specialization of the intermediaries. The "reserved activities" that characterized financial operators by type are constantly decreasing at both the normative and operative level. As a matter of fact the traditional tripartite division of the financial market failed to take into consideration that the creation and allocation of savings among

[19] The literature available to date on both fronts is not vast. An important contribution is Goodhart (1988). Attention is also called to a recent empirical work by Franks, Schaefer and Staunton (1997) on the direct and indirect costs of the regulation of financial markets, which among other things evidences the absence of research on the benefits of regulation.

sectors with a cash surplus and sectors with a cash deficit were basically unitary phenomena: hence, a unitary view of financial intermediation and its regulation should be adopted.

In the case of Italy, the processes of integration within the financial market have come about in a rather articulated fashion.

As regards the intermediaries, ownership integration has been accentuated, coming about mainly through the transfer of capital shares among institutions, or among controlling and controlled firms[20] . Another form of integration among intermediaries may be detected in the transformation of their legal status, even when continuing to perform basically the same intermediation activities as before. This occurred in particular with investment firms (SIM - società di intermediazione mobiliare) which have been legally transformed into banks, even though they have not as their primary objective the issue of deposits or the provision of loans. The reasons for this "arbitrage" among legally diverse forms are multiple: access to credit of last resort and to the interbank liquidity market; possibility of directly managing customers' liquidity; concerns about a sounder image ("too bank to fail"); differing modalities for crisis management; different regulatory costs; different supervisory authorities to have to deal with.

As regards the markets, considerable integration has taken place between the banking/insurance markets and the securities markets. This occurred by virtue of the issue and quotation on either the Stock Exchange or other markets of securities (equities and bonds) of both banks and insurance companies. The Italian financial market is thus experiencing a progressive coincidence between issuers and financial intermediaries.[21] This feature is likely to develop even further. These intermediaries have in fact become, with the "privatization" process of the Stock Exchange and of the MTS (the Wholesale Government Bonds Market), owners and managers in the same regulated financial markets, which have been transformed into corporations. Recently, some banks have also started to manage directly alternative trading systems (as the TLX, by Unicredito Italiano).

As regards the integration among financial instruments, we observe that many of these, while keeping their legal status, have rapidly changed their economic function. This is due to both exogenous factors -- such as fiscal considerations, or different regulations applied to similar financial tools – and to endogenous factors -- such as the different behavior of sellers and buyers (here we refer in particular to certificates of deposit and bonds issued by banks, and to certain types of life

---

[20] For a detailed and analytical description of the issues in Subsections III1 e III2, see Di Noia e Piatti (1998).

[21] This phenomenon seems to be peculiar to Italy. Data on stock exchange capitalization indicate that the weight of the financial sectors in the Italian stock market is much higher in 1998 (42.4% of market capitalization) than in other advanced countries (18.2% in the US, 26.4% in France, 33.7% in Germany, 26.9% in the UK, 18.2% in Japan). See IRS, Rapporto sul Mercato Azionario 1999.

insurance policies).

The role of insurance companies as financial intermediaries is also constantly increasingly, thanks to contracts involving life insurance and capitalization, whose services are directly tied to investment funds or to stock exchange or other financial indices (so-called unit-linked or index-linked contracts).[22] Nowadays, the inclusion of the life insurance segment among those activities subject to financial regulation is something accepted in the major financial systems. Over the last few years, market changes have actually lessened the distinctiveness of some schemes of life insurance compared to other financial products. In the English system, for instance, long-term life insurance contracts are included in the notion of investment (financial instruments) as provided by the Financial Services Act of 1986. This law and its implementing rules regulate the selling of long-term business (life and pensions, see also Boléat, 1998). Insurance companies have the same treatment of unit trusts in terms of their selling activity. The recent establishment of the FSA will further reduce the distinctiveness of insurance companies by applying a common regulation to all financial institutions. In the U.S. system, variable annuities and variable life insurance contracts whose yield is tied to "separate accounts"[23] fall under the Investment Company Act of 1940, which provides the general guidelines relative to investment activities, reinvestment, and the buying and selling of financial securities. Besides, as contract owners assume certain investment risks under variable contracts, the contracts are securities under the Securities Act of 1933. In Italy, on the contrary, insurance companies are excluded from the set of rules that apply to banks and to other financial intermediaries. The exemption from such rules derives from the fact that life insurance policies are not considered financial instruments (see Article 1 of the Finance Law) and that insurance companies are not authorised to perform investment services. Although there is an increasing tendency to recognise the high degree of contiguity between certain insurance products and typical financial products, the regulatory differences in the Italian system remain significant. Italian insurance companies are supervised and controlled by only one supervisory authority, the Isvap (Istituto di Vigilanza sulle Assicurazioni Private).

III.2 THE REGULATORY MODEL.

Financial markets regulation in Italy has been obviously affected by the structure and the evolution of the financial system. It was traditionally focused on banking intermediaries. The major

---

[22] Whenever an insurance company offers these kinds of financial products, it unquestionably falls into the category of subjects engaged in the activity of financial intermediation, as it is linking economic sectors in surplus with those in deficit.

[23] In such contracts, the value of what the owner may receive during the pay-in (and sometimes the pay-out) period depends upon the investment performance of the separate account into which his or her payments have been invested.

changes in the past three decades have come about under the pressure of both the European directives and of increasing cross-border financial market integration. Such changes have been grafted onto a regulatory system whose basic approach was to carve a three-way division of the financial market into banking, securities and insurance sectors. This division was reflected in a three-way division of the intermediaries and a corresponding division of the regulatory authorities: Banca d'Italia, Consob (Commissione Nazionale per le Società e la Borsa) and Isvap. New regulations were frequently introduced and in a rather uncoordinated fashion. The final outcome is a structure of controls which is difficult to classify into any one of the theoretical models previously illustrated. The distribution of competencies among the different supervisory authorities is in fact characterized by a "mixed" approach (See Table 1).

As for insurance companies, the institutional model is followed (with Isvap supervising them for stability and transparency). The institutional model is partly used also for banks. They are supervised by Banca d'Italia for stability and transparency in all typical banking activities (deposits and loans), as well as for those aspects regarding competition (Law 287/1990 excludes the Antitrust Authority from having primary control over banks).

Then, there is the case of pension funds where a mixed institutional-functional approach is used. Here an activity, the payout of private pensions, is reserved to well-specified financial intermediaries while at the same time being an exclusive object coming under the control of Covip (Commissione di Vigilanza sui Fondi Pensione). Nevertheless, the Ministry of Labor issues general directives in the matter of the supervision of pension funds (with the Ministry of the Treasury), and supervises the Covip. The Ministry of Labour does also authorize the exercise of this activity, while the Ministry of the Treasury, after hearing the Commission's opinion, issues regulations setting limits and criteria in the matter of investments, and the rules to be observed in the case of conflicts of interest.

The model by objectives formally characterizes the regulation of entities officially authorized to perform investment services, with regard to such activities: banks, investment firms, investment management firms, mutual funds and Sicav (Società di Investimento a Capitale Variabile). These intermediaries are supervised by Consob insofar as transparency and investor protection and by Banca d'Italia insofar as "limitation of risk and financial stability" (Article 5, Paragraphs 2-3, Finance Law). Moreover, the Antitrust Authority has exclusive competence for the rules on competition for all authorized subjects with the exception of banks.

A supervisory model by objectives seems to emerge with respect to the entire securities market, and not just to the intermediaries. The recent evolution of the normative framework assigns to the Consob all the powers in the field of transparency in the market (secondary regulation of the solicitation of public saving, of insider trading, of takeovers and public offers, etc.). Similarly, Banca d'Italia might be considered responsible in the matter of stability (regulation -- not necessarily exclusive -- of compensation, liquidation, clearing houses, wholesale securities markets, central depository, settlement systems, etc.). The Antitrust Authority might be considered responsible for guaranteeing competition among different exchanges.

Table 1: Competent Authorities for the Supervision of Financial Intermediaries in Italy.

Intermediaries ⇓ Objective ⇒	**Stability**	**Transparency and Proper behaviour**	**Competition**
Banks	BankItalia, Cicr, Min.Tesoro	BankItalia, Cicr, Consob, Min.Tesoro (Antitrust)	BankItalia (Antitrust)
Investment Firms	BankItalia, Min.Tesoro	Consob, (Antitrust)	Antitrust
Life Insurance	Isvap, Cipe, Min. Industria	Isvap, (Antitrust), Cipe	Antitrust, (Isvap), Cipe
Investment Funds	BankItalia, Min. Tesoro	Consob, (Antitrust)	Antitrust
Pension Funds	Commissione Fondi Pensione, Min.Lavoro, Min.Tesoro	Commissione Fondi Pensione, Min.Tesoro (Antitrust)	Antitrust

III.3 CURRENT REGULATORY PROBLEMS.

Our previous description of the regulatory framework adopted in the Italian financial system should have already indicated the presence of some rather peculiar features. In this paragraph we want to underline those peculiarities that we view as regulatory problems.

Many of these problems derive from the dominant role traditionally performed by banks in the Italian financial system, and hence from their regulator, the central bank. A premise is necessary: for a long time the Bank of Italy has been representing a relevant and positive exception in the Italian public administration sector. However, a logically incoherent assignment to the same institution of mutually conflicting tasks might still be dangerous and lead to an inefficient functioning of the financial system. This is true with regard to the regulatory objectives as well as to the policy instruments that can be activated in order to reach the former.

A first problem is that of having banking supervision conducted in a regime of monopoly by the central bank[24]. This feature is unique among G-7 countries. Even though we will not discuss it here, we want to underline that the problem has only partially been solved with the start of the EMU and the assignment to the ECB of full responsibility for monetary policy in the Euro area. As a matter of fact the national central-bank governors participate to formulate the monetary policy strategies and decisions and are responsible for their implementation in the domestic economy. Hence, so far there is no complete separation of tasks.

A striking anomaly, which is unique in the Euro area, is represented by the assignment to the Bank of Italy of the task of preserving competition in the banking sector. We do not think that there is any motivation nowadays to give such a responsibility to an Institution different from the one (the Antitrust Authority) that supervises this feature in all other economic sectors. The rationale of this regulation is to be found in the fact that the Antitrust Authority was established only recently in Italy (1990). In absence of such an Institution, the possibility that dominant coalitions and excessive market power could arise in the banking sector was considered too dangerous and justified the assignment of the task of preserving competition in the market to the already existing Institution controlling the banking system for prudential supervision. Today, however, no reason remains to assign the same objective of regulation to different Institutions in different sectors.

Moreover, it is logically incoherent to assign responsibility for competition in one sector to the same Institution that is responsible for the stability of the same sector. As already stressed, at least in the short run, an obvious conflict emerges between the two objectives of stability and competition. And, as a matter of fact, in many of the M&A operations in the Italian banking sector, the opinions of the Antitrust Authority (which are not compelling) and those of the Bank of Italy have been opposite (Cafagna and Sciolli, 1996). A competitive market is by nature unsteady, in the sense that allows for the entry of new firms and the exit of the inefficient ones. In recent periods there were examples of this peculiar role of the Bank which stopped some takeovers of some banks

[24] See Di Noia and Di Giorgio (1999) for an updated discussion of the pros and cons of separating monetary policy

over other banks because they were hostile. Beside, the Bank stated that it is necessary for the Bank to know in advance any intention to launch a takeover: but in the event of listed banks, reasons of investor protection would make necessary that any price-sensitive news should be disclosed to the market, or at least to the market authority.

The Authority which is responsible for the stability of the system could indeed have a regulatory bias for the protection of firms that should be left to exit the market. The usual motivation of the risk of contagion and of investors protection would be advocated. However, we think that the risk of contagion is not necessarily and inevitably linked to all single bank crisis. Moreover, this risk could be countered with other instruments, including more transparency and information diffusion in the market.

We also think that there is no clear argument to protect the interest of investors other than bank depositors. Why should the bond and equity holders of a bank be more protected than those of a non financial firm? In addition, we should also notice that the "small and naive" depositors are already protected by an explicit deposit insurance system.

Another anomaly in the Italian financial system is that the Bank of Italy owns relevant shares and equities of either banks or other financial institutions controlling banks. The Bank of Italy invests in equities both part of its ordinary reserves and part of the contributions of the employees' pension fund.[25] Quite obviously, monetary policy decisions in terms of interest rates (previous to the start of the EMU) and the supervisory and regulatory decisions have such a relevant effect on the profitability conditions of the supervised entities that the Central Bank should be not allowed to be a shareholder of the same entities. At least, its equity investments should be decided and managed by one or more totally independent and autonomous financial manager.

Another problem stems from the different regulation given to life insurance firms, particularly when they act purely as financial intermediaries. The life insurance industry, throughout contracts such as unit and index-linked schemes, has been gradually losing its distinctiveness. We think it should no longer be regulated as a different function from banking and financial investment, nor having its own regulator. A step in this direction may be represented by a recent decree approved by the Italian Parliament (February 2000) on the fiscal treatments of pension funds, which establishes equivalent fiscal regimes for mutual funds and unit and index-linked short term contracts.

---

responsibilities from the ones for banking supervision and regulation. See also Goodhart and Shoenmaker (1992).

[25] Some data: by the end of 1999, the Bank of Italy owned shares higher than 2% of the company capital in 10 listed firms, including a bank (Italfondiario, 8%), a financial holding company (IFI) and many insurance companies (Alleanza, Generali, INA, La Fondiaria), that in turn were either involved in the control of, or controlled by, other Italian banks, whose supervisor is Bank of Italy itself.

III.4 PROSPECTS FOR REGULATORY REFORM OF THE ITALIAN FINANCIAL SYSTEM

In this subsection, we shall present the basic lines of our operative proposal for a regulatory reform of the Italian financial system. With the Finance Law, Italian legislators have already begun to reorder competencies among the various supervisory authorities. We think that it would be wise to go further. Regulatory arrangements in the Italian financial system should be organized according to a clear division of competencies strictly in line with the "by objective" model. The object of such a regulatory change should be the entire securities, banking and life insurance market.[26]

The authority responsible for (micro) stability should supervise the stability of the entire financial market and of single financial intermediaries whether in banking, securities or insurance (authorizations; professional registers; supervision in the area of information, regulations and inspections of intermediaries and conglomerates; other matters regarding stability; crises management). We think that this authority should also manage deposit insurance and the investor compensation scheme. In fact, the current agencies (the FITD- Fondo interbancario di Tutela dei Depositi, and the Fondo Nazionale di Garanzia) have no regulatory and supervisory powers at all. These agencies simply act as the cash management department of other regulating institutions when reimboursing depositors and investors. There are clearly cost reductions that could be achieved by their elimination. As regards macroeconomic stability, this authority should only cooperate with the central bank in supervising security settlement and payment systems and clearing houses; but it could be charged with supervision over financial instruments in wholesale markets, with particular regard to government bonds and derivatives.

The 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).

The authority for competition should guarantee fair competition, and should avoid abuses of dominant position and limit dangerous concentrations in banking, security and insurance sectors. A

[26] In terms of international application, a regulatory structure embracing the whole financial market including the insurance market is to be found both in the previously-cited English and Scandinavian reforms and in the reform of the Australian system. The Australian reform establishes a clear division of competencies by objectives, excluding, as in the United Kingdom, the central bank from microstability controls over intermediaries.

non-binding opinion of the authority for stability might be contemplated in certain instances.

As we have previously mentioned, the major problem of supervision by objectives is the possible duplication of supervisory activities. The necessary coordination and resolution of eventual controversies could be provided by a Commission for the Supervision of the Financial System (as in the Corrigan Report - Corrigan 1987) which would assist the Ministry of the Treasury, which in turn should be charged with oversight in the area of fund gathering, credit practices and other financial activities. The commission would be the natural place for activities involving proposals and consultation concerning measures regarding financial market regulation.

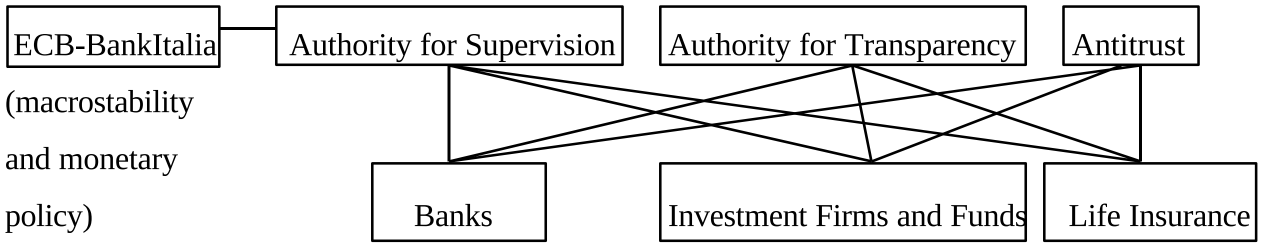
In practice, we propose the following major reforms for the Italian financial regulatory framework:

1) To create a new Institution (Financial Supervision Authority) responsible for financial supervision by separating the Banking Supervision Department of the Bank of Italy (*Vigilanza*) and merging it with the deposit insurance fund (FITD).
2) To assign to the Financial Supervision Authority responsibilities in terms of microeconomic stability of all financial intermediaries, including banks, investment firms, institutional investors, life insurance companies and pension funds. Macroeconomic stability and controls over security settlement and payment systems should be left under the responsibility of the Bank of Italy.
3) To subtract any responsibility in terms of competition in the banking and insurance sectors to either the Bank of Italy or the ISVAP and assign them only to the Antitrust Authority.
4) To assign to the CONSOB all powers and responsibilities in terms of transparency, disclosure requirements, investor protection and misleading advertising in all financial markets.
5) Covip should be abolished; ISVAP would be responsible only for the activities of the insurance companies which are not alike those of other financial intermediaries (*ramo danni*).

Our three distinct independent authorities ought to be characterized by homogeneous procedures in terms of their creation, functioning and funding, as well as by similar attributions of powers.[27] A sketch of our proposal based on a "four-peak" model of financial regulation follows (Figure 1).

[27] See Di Noia and Piatti (1998).

Figure 1. A 4-Peak Model for Financial Regulation



IV. FINANCIAL STABILITY AND REGULATION IN EUROPE.

In the recently established Euro-area, and given the increasing integration among European financial markets, it could seem quite useless to present proposals of institutional reforms for financial market regulation that are limited to single countries. In this section, we will argue that a natural extension to the financial system at the Euro level of the regulatory model by objectives could be considered a good candidate to solve some problematic issues regarding financial stability and the need for more coordinated transparency and investor protection rules. These topics are currently at the centre of a lively debate (see Padoa Schioppa, 1999; Lannoo, 1999; Vives, 1999).

We start by observing that in the European Monetary Union (EMU), the principle of separating monetary policy and banking supervision responsibilities has been clearly established in the statute of the European Central Bank (ECB). The latter empowers the ECB to set out and conduct monetary policy in the Euro area, but leaves the responsibility for banking supervision to the national authorities. It could be argued that a problem of institutional separation between monetary policy and banking supervision agencies does not exist any longer in the Euro area[28] , even though in countries where the national central bank (NCB) is a monopolist in banking supervision, the separation is not complete as the NCB Governor does also participate to the definition of the general strategies of European monetary policy which are set out in the ECB Governing Council.

However, as argued above, the term banking supervision should be replaced by that of financial supervision. The stability of the financial system could not be so much at risk because of the loan/deposit activities performed by banks. Instead, financial instability could be induced by activities linked to portfolio management, which are typical of investment banks and securities firms.[29]

[28] In fact, "even in countries where the competent authority for banking supervision is the central bank, by definition this authority is, functionally speaking, no longer a central bank, as it lacks the key central banking task of autonomously controlling money creation" (Padoa Schioppa, 1999).

[29] A well known recent example of a serious threat to financial stability is the LTCM case. Here, a non bank institution was rescued thanks to the moral suasion of the FED, that is not responsible for the supervision of hedge

The real problem to tackle should then be that of who takes care of financial regulation and supervision in the EMU. At the moment there is no clear assignment of roles and responsibilities agreed upon at EU level. However, we think that there is no point in having a common monetary policy and aiming at an always more integrated financial system in the Euro area while keeping different financial regulations and supervising rules in each member country. As a matter of fact, these institutional differences are an important barrier to further financial integration. In this field, the principle of minimum harmonization and mutual recognition, that was originally thought to be able to naturally induce over time a convergence of regulatory behaviour and more uniform rules, clearly 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 obvious incentive to promote less demanding domestic financial regulations and supervision in order to let the own country become more attractive for running financial business; while 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 (see below). Finally, with increasing international banking activities and a European real time gross settlement system in place (Target), the argument that domestic regulators and supervisors have better knowledge and can exercise more efficient control becomes day by day less effective (See Prati and Schinasi, 1999).

Another important point is that no clear tool nor any responsibility to counter and/or manage the risk of financial instability and crisis has been established in Europe. The Treaty is silent on this topic. It is not even evident that the role of lender of last resort will be performed by the ECB, as it would be desirable being an essential function of a central bank. In fact, this solution will probably occur only in the case of a widely spread liquidity crisis affecting the whole Euro area. But what will follow a liquidity crisis located in a single country? And what 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? One of the typical forms of public intervention seems lost, and probably the most natural, that of central bank last resort loans. The ECB will not intervene in favour of a single institution, especially if its financial links are mostly domestic. Also because it could always assign some of the responsibility for the crisis to the domestic financial regulator-supervisor. The domestic central bank can not intervene by providing funds without an explicit authorization by the 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 Bagehot's doctrine

---

funds.

(1873), and / or that the risk of potential spread and contagion of the crisis is high.[30] This requires time and resources. The other two traditional instruments, bail out through a safety net provided by the banking system or through the government budget will ultimately shift the burden on the shoulders of domestic taxpayers, especially in the framework established in the Stability and Growth Pact. Given the current level of taxes in Europe, this is hardly an optimal solution.

We think that a much higher degree of co-ordination in the field of financial regulation and prudential supervision is both desirable and needed in the EMU. Our view is not limited to the banking system but embraces all financial intermediaries. A somehow good example of international cooperation 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. On the contrary, the securities supervision has not succeeded in establishing a similar long record of international rule-making. In a world of complete mobility of capital and financial services, where institutions and markets operate without frontiers, supervision should operate at the same level, that is to say, it must be structured internationally[31] . Moreover, following the view we adopted on the national base, we think that the European supervisory system would gain both in consistency and effectiveness if all stability oriented rules, all transparency oriented rules and all competition oriented rules for all types of financial institutions were either issued or (may be better) coordinated by distinct independent agencies at the Euro area.

Of course, we are aware that it is not easy to structure and create such an integrated system of rules and institutions in the EU, that it will require time, resources and a widespread collaborative attitude. Hence, we list not one but three possible paths of institutional changes that can reintroduce the function of lending of last resort in the Euro zone and at the same time allow for a sounder scenario in case of a financial crisis. The last solution is the one we prefer, inspired by the same logic we used for our proposal of reform of the Italian financial system. However, we view also the other two following ways as better solutions with respect to the current situation.

1) A first possibility is to assign supervisory powers and responsibilites in the banking sector to the ECB. However, even leaving aside the arguments against the solution of merging banking supervision and monetary policy, this arrangement would still be not satisfactory and would require other institutional changes, as it would be certainly desirable to have a common supervisor for all financial intermediaries. The Maastricht Treaty would then have to be amended, as it explicitly

[30] See Freixas et al. (1999), Bruni and de Boisseu (1999), and De Cecco (1999).

[31] This does not necessarily lead to the creation of a European SEC (see Lannoo 1999a, Karmel 1999), even though such hypothesis could become realistic in the medium run.

forbids that supervisory powers regarding insurance firms be assigned to the ECB.

2) A new European System of Financial Regulation (ESFR), structured similarly to the ESCB, could be established. A European Financial Regulation Authority (EFRA) should be at the centre of the system. The EFRA should be formally separated by the ECB, both in order to avoid excessive concentration of powers as well as for other arguments.[32]

In a first stage (3 years?), the EFRA 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. This central agency should sponsor the necessary institutional change at domestic level leading to merging and re-organization of supervisory and regulatory powers in the financial sector of each member country. At the end of the process, in each country there will be just one national agency, similar in structure to the Financial Service Authority recently established in the UK. This national agency will participate to the definition of the general strategies and principles of financial regulation in the area, becoming a member of the ESFR. It will be responsible for the implementation in the domestic country of both the rules and the supervisory duties agreed upon at the Euro level.[33] In each single country, this agency will be the sole responsible for financial stability and correct disclosure of all financial intermediaries - being in charge of banks, securities firms, mutual, pension and hedge funds, life insurances - and of all securities markets

3) Establish two new different European Agencies, one responsible for the microeconomic stability ("European Financial Supervision Authority") and one for the transparency, investor protection and disclosure requirements ("European Authority for Market Transparency") of all financial intermediaries. The two central agencies should co-ordinate the different domestic agencies in each member country. In this solution, we will then have two different European systems of financial regulators, according to the principles that suggest to replace "institutional" regulation by "functional regulation" (or by objective).

Under both 2) and 3), no antitrust power will be given to any member of the ESFS, 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 exist at both Euro and domestic levels. We think that it would be wise to transform in a third separate and independent

---

[32] See Di Noia and Di Giorgio (1999). Another relevant issue is "who pays for financial supervision and how much it costs". An attribution to the ECB of these functions could be less transparent given that they may be confused in the monetary policy ones (thus inducing lower accountability).

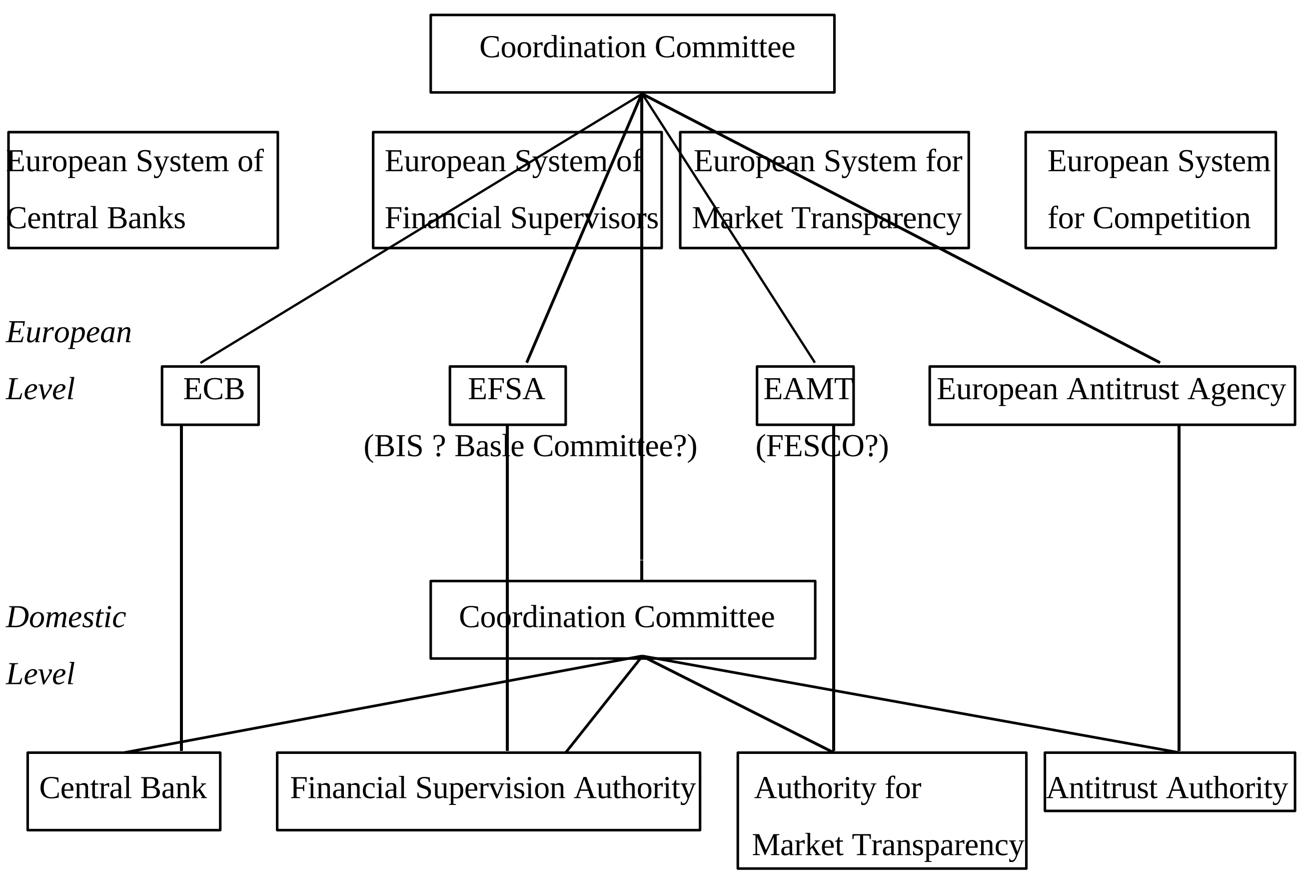
[33] Both the national and the central European levels of financial supervisors should exist, given the current level of harmonization in the financial market legislation, which is far from complete, in particular with respect to taxation, accounting rules and banking crises management.

central agency the EU Antitrust DG. This will then coordinate and promote the harmonized activities of domestic Antitrust agencies. In each member state, the national Antitrust agency will safeguard competition in all economic sectors.

A special Committee (and desk) for the lending of last resort function could be established at the ECB, with the participation (only for information and communication purposes) of members of the (one or two) ESFS. The ESFS (or the one responsible for "supervision") will promote the participation of intermediaries, in each country, to a limited insurance fund that could provide good quality collateral to institutions facing liquidity problems in order to be able to qualify for central bank financing. The national agency will manage the fund and assess whether an institution is just illiquid or insolvent. In the latter case, provision of collateral should be denied. The domestic government could still decide whether to bail out the institution or not, being responsible and (politically) accountable for the decision.

Our suggested 4 - peak model for financial regulation in Europe is sketched in figure 2.

Figure 2: European System of Financial Regulation



V. CONCLUSIONS.

In this paper we argued that financial market regulation should be re-designed and harmonized in Europe according to a regulatory model by “objectives” or “finalities”. We have first analyzed the case of Italy and sketched a comprehensive proposal for the reform of its financial system regulation. This would call for assigning to three distinct and independent agencies (separated by, but coordinated with the central bank) all supervisory powers and regulatory responsibilities in financial markets and on financial intermediaries, regardless of these being insurance companies, banks or investment firms. One agency should be responsible for financial microstability, another for transparency and disclosure requirements, and the third for protection of competitive features in the markets.

In view of the criticism addressed to the current assignment of financial regulatory and supervisory powers in the EU, we think that the previous scheme could be extended and nested into a wider context as the Euro area. In particular, we are in favour of the establishment of two new European financial regulation agencies, each formally separated by the ECB. These agencies should be responsible for the comprehensive co-ordination of both legislation and execution of regulation in financial markets: the first European agency should 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 nonfinancial) markets is already safeguarded by having the Antitrust General Direction of the European Commission plus the domestic agencies. It would be wise to transform in a central and independent European agency the EU Antitrust General Direction. The latter and the two newly created central agencies will be at the centre 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. A 4 - peak regulatory model “by objective” would be in place in the Euro Area as well as in each member country.

REFERENCES

Allen F. and Santomero A., 1997, "The Theory of Financial Intermediation", *Journal of Banking and Finance*, n. 11.

Allen F. and Gale D., 1998, "Innovations in Financial Services, Relationships and Risk Sharing", *Journal of Political Economy*.

Blinder A., 1998, Central Banking in Theory and Practice, MIT Press, Cambridge.

Boléat M., 1988, “The Insurance Industry and the Financial Services Authorities”, *Journal of Financial Regulation and Compliance*, vol. 6. No. 1.

Briault C., 1999, “The Rationale for a Single National Financial Services Regulator”, *FSA Occasional Papers*, n. 2.

Bruni F. and de Boissieu C., 1999, “Lending of Last Resort and Systemic Stability in the Eurozone”, paper presented at the Conference on the Lender of Last Resort at LSE.

Cafagna L. and Sciolli S., 1996, “Ruolo e responsabilità delle istituzioni: l’Autorità Antitrust”, in AA.VV. Quali banche in Italia? Mercati, assetti proprietari e controlli, Edibank, Milano.

Calomiris C. and Litan R., 1999, “Financial Regulation in a Global Marketplace”, mimeo.

Coffee J., 1995, "Competition versus Consolidation: the Organizational Structure in Financial and Securities Regulation", *Business Lawyer*, n. 2.

Corrigan G., 1987, Financial Market Structure: a longer view, Federal Reserve Bank of New York.

Dale R., 1997, "Reorganizing the regulation industry", *Financial Regulation Report*, n. 2.

Davies H., 1997, “European Central Banking – East and West: Where Next?”, *Bank of England Quarterly Bullettin*, May.

Dewatripont M. e Tirole J., 1994, The Prudential Regulation of Banks, MIT Press, Cambridge.

Di Noia C. and Di Giorgio G., 1999, “Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?”, *International Finance*, 3.

Di Noia C. and Piatti L., 1998, “Regolamentazione e mercato finanziario: analisi e prospettive di riforma per il sistema italiano”, *Quaderni di Finanza CONSOB*, n.30.

FSI, 1997, Financial System Inquiry Final Report, Australian Government Publishing Services.

Franks J., Schaefer S. and Staunton, M., 1997, "The Direct and Compliance Costs of Financial Regulation", *Journal of Banking and Finance*, n. 11.

Freixas X., Giannini C., Hoggarth G. and Sousa F., 1999, “Lender of Last Resort: a Review of the Literature”, *Financial Stability Review*, November.

Giannini C., 1998, “Enemy of None but a Common Friend of All? AN International Perspectiv eon the Lender of Last Resort Function”, Banca d’Italia *Temi di Discussione* , n. 341.

Goodhart C., 1996, "An Incentive Structure to Financial Regulation", *Special Paper*, LSE Financial Markets Group, n. 88.

Goodhart C., 1999, “Myths about the Lender of Last Resort”, *International Finance*, 3.

Goodhart C. and Shoenmaker D. (1992), "Institutional Separation between Supervisory and Monetary Agencies", *Giornale degli Economisti e Annali di Economia*, n. 9-12.

Karmel R., 1999, “The Case for a European Securities Commission” Columbia Journal of Transnational Law, vol. 38.

IOSCO, 1998, Objectives and Principles of Securities Regulation.

Lannoo K., 1999a, “Do We Need a European SEC? Securities Market Regulation in the EU”, mimeo.

Lannoo K., 1999b, “Financial Supervision in EMU”, mimeo.

Llewellyn D., 1999, “The Economic Rationale for Financial Regulation”, FSA Occasional Paper.

Merton R. and Bodie Z., 1995, "A Conceptual Framework for Analyzing the Financial Environment”, in Crane D. *et alii*, The Global Financial System, A Functional Perspective, Harvard Business School Press, Cambridge.

Oldfield G. and Santomero, A., 1997, "Risk Management in Financial Institutions", Sloan Management Review, Fall, Vol. 39.

Onado M., 1999, “The Consequences of European Financial Integration for the Regulatory Authorities”, mimeo.

Padoa-Schioppa T., 1988, "Sistema finanziario e regolamentazione", *Bollettino Economico*, Banca d'Italia, n. 11.

Padoa-Schioppa T., 1997, Il governo dell'economia, Il Mulino, Bologna.

Padoa-Schioppa T., 1998, “Global Supervision: a Term in Search of a Content”, *BNL Quaterly Review*, Special Issue, March.

Padoa Schioppa T., 1999: “EMU and Banking Supervision”, *International Finance*, 2.

Stiglitz J., 1993, "The Role of the State in Financial Markets", Proceedings of the World Bank Annual Conference on Development Economics.

Taylor M., 1997, "Redrawing the regulatory map: A proposal for reform", *Journal of Financial Regulation*, n. 1.

Taylor M. and A. Fleming, 1999, “Integrated Financial Supervision: Lessons of Scandinavian Experience”, *Finance and Development*.

Vives X. (1999): “Banking Supervision in the European Monetary Union”, mimeo.

White L., 1996, "International Regulation of Securities Markets: Competition or Harmonization?", in Lo A. (ed), The Industrial Organization and Regulation of the Securities Industry, NBER, Cambridge.

White L., 1997, "Technological Change, Financial Innovation, and Financial Regulation: the Challenges for Public Policy", Wharton Financial Institutions Center w.p. 33.

Wilson J., 1989, Bureaucracy, Basic Books.