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The Future of Banking Supervision in Europe

"Supervision of International Banks: Is a Bank Crisis still Possible in Europe?" – European Banking Federation (FBE)

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Introduction

First of all, I would like to thank Michel Pébereau and the European Banking Federation for inviting me here today to participate in this conference on important issues relating to the future of banking supervision in Europe.

Usually I speak from the perspective of the Basel Committee on Banking Supervision. Today, however, I will mainly take the viewpoint of one of the central banks of the Eurosystem with banking supervisory responsibilities.

The subject of this debate is particularly timely, given the European Commission's current initiative to define financial services policy for the EU over the next five years, to which I understand the FBE has been an active contributor.

I would like to use my time this morning to suggest a number of principles that I believe could help in addressing the key challenges for European banking supervision structures in the coming years, and also to reflect on some concrete steps to build a European framework fit to meet these challenges.

What is the main issue we face?

There is no need for me to explain the dichotomy that arises when we have, on one hand, an industry that is becoming increasingly internationalised in nature and, on the other, a supervisory framework that remains predominantly based on national responsibilities and accountabilities.

In a context where banking groups increasingly take decisions and manage risks on a global basis, inconsistencies or differences in the regulation and supervision across the countries in which they are active may create compliance costs and inefficiencies. Furthermore, adverse developments in one bank are more likely to have financial stability implications for several countries. These issues are certainly not exclusive to the EU. But the existence of the EU project adds an extra dimension, which brings challenges, responsibilities and also opportunities.

Progress has been made in building the single market in financial services, but we are not there yet. In some segments of the financial markets, such as retail banking, there is a long way to go to achieve a fully integrated market. And recent experiences in relation to some cross-border acquisitions seem hardly compatible with the spirit of the single market. We face, therefore, several challenges: to safeguard the efficiency, effectiveness and consistency of supervisory action in more global and integrated financial markets; and to reduce the remaining obstacles to cross-border finance, both in terms of cross-border consolidation and in the provision of products and services.

Some of these national differences have developed over a long period of time and go beyond the prudential or supervisory sphere. Political initiatives to reduce regulatory inconsistencies would substantially support the supervisory convergence efforts.

At the same time, there is a political objective to enhance the dynamism and competitiveness of the EU economy – the so-called "Lisbon" objective – and an efficient, integrated financial market is an important part of achieving it.

The fact is that if we are to reap the full benefits of European integration, and meet the political objectives set in Lisbon, we need to find ways to ensure that the banking industry can operate with maximum efficiency and also that supervision is not unduly burdensome and promotes a level EU playing field. But we need to do this while also ensuring that depositors are adequately protected and that financial stability is preserved. In summary, the challenge is how to ensure both minimum gaps and minimum overlaps in supervision. Much progress has already been made in the banking context, but it is necessary to go further.

What should be the guiding principles for a European approach to dealing with these challenges?

There are a range of views on how EU banking regulation and supervisory structures should face up to the challenges of the 21st century. What's more, these opinions are not static, which makes for a complex situation.

Among the most ambitious perspectives are those which advocate a single EU banking or financial services supervisory authority. Others – including the European Banking Federation – promote the idea of a "lead supervisor" approach, providing banking groups with a single interlocutor which has powers relating to the group as a whole.

Both proposals raise significant political, legal and practical issues. Yet it is clear that the status quo will not be sufficient in the future. We need to move forward. And we need arrangements that reduce compliance costs for banks and streamline their interaction with supervisory authorities if we are really to make progress in integration. I think the key to success will be pragmatism, both on the part of the supervisory authorities and on the part of the industry.

Let me highlight the principles that I believe should guide us in finding a way forward. I will begin with four principles which could be classified as being on the prudent side of the debate.

Firstly, I believe that we need an approach which ensures legal clarity for all concerned. Banks need to know what requirements they should meet, on what basis and in which countries; supervisors need to know what activities they are responsible for and who they are accountable to; and depositors need to know where they can turn and on what basis if things go wrong. Informal

arrangements between supervisory authorities can be extremely useful. But they do need to be grounded on firm and clear legal settings and accountability mechanisms.

Secondly, we must recognise the diversity of situations within the EU. The European banking industry is far from homogenous. Just focusing on the international aspects, let me mention two points: first, only a handful of the thousands of banking institutions in the EU can be considered as truly pan-European, even though these institutions make up a significant part of the banking market. In the same vein, a significant proportion of banks in a number of the new EU member states are foreign-owned. Clearly, pan-European institutions are key to the EU's position in the global system, and we must do everything we can to ensure they can play their role. But we also need to be careful that any measures we take in the interests of promoting greater efficiency for international institutions do not impose undue expense on smaller institutions, and we must take a perspective that is acceptable for both home and host supervisors.

My third point is linked to this, and concerns the need to observe the principle of subsidiarity, a key tenet of the EU which says that action should only be taken at EU level where national or local action cannot have the desired effect. This principle is particularly relevant given the continued diversity of the EU banking industry and consumers. Supervision is best conducted close to the markets and institutions.

Last but not least, I believe we need an approach which is realistic in the short to medium term. It is essential that the industry keeps considering the issues and expressing its ideas, but I am afraid that unrealistic expectations can only lead us to an agonised debate which could polarise views and even hinder the progress that we need to make now in the crucial and urgent work of implementing Basel II, and international accounting standards.

As I mentioned earlier, these were the more prudent principles that I wanted to mention. But, as the 19th century English writer Charles Caleb Colton said, "there is nothing more imprudent than excessive prudence". Therefore, let me add a further four principles that go more in a more progressive direction.

Firstly, I think that the EU needs to be ambitious, and set an example. I am convinced, and have said in many of my recent interventions, that the EU can and should go further, deeper and faster than the wider international community in finding greater consistency, convergence and efficiency in banking supervision. We should especially take advantage of the opportunities presented by Basel II and the fact that we already have a body of single market legislation and a long history of supervisory co-operation on which to build. And if we can demonstrate that progress is possible among 25 countries that are still rather diverse, others will have more confidence to push ahead also.

Secondly, we should recognise the legitimate concerns of the industry. More efficient supervision is a necessary - although not sufficient - condition for a more integrated market. We undoubtedly need a greater degree of co-ordination between supervisors than hitherto, and we need greater consistency in supervisory practices. As I said, we need a framework that rationalises the compliance burden and streamlines the interaction between supervisory authorities. We need banks that manage risks, not unnecessary supervisory requirements.

Thirdly, we need an approach that uses the full range of tools at our disposal. In other words, we should not just look for legislative solutions to the challenges that face us. What we need is effective and timely implementation of the laws and regulations that exist, and convergence in their application. This comes through co-operation and information-sharing between supervisors.

And let me also mention here the potential offered by supervisory transparency. We have heard much about market discipline in the context of the disclosure requirements that will apply to banks under pillar 3 of the revised Basel capital framework. But I think that increased disclosure by supervisors, especially on a comparable basis, also has an important role to play, not only in helping us to monitor consistency of approaches across countries, but also in driving greater convergence through exerting a kind of market discipline for supervisors.

Finally, allow me to put my Basel hat on for a moment. I think Basel II certainly offers its fair share of implementation challenges, but also provides us with by far the biggest opportunity to make progress in building a more consistent and efficient co-operative approach to supervision.

I have mentioned four prudent principles, plus another four more forward-looking ones. Some may emphasise the former, while others may prefer to move faster. My own view is that there is some urgency in moving forward significantly.

Building the European framework

So let us now focus on the concrete steps that move in this direction. I would like to separate these into two categories: those that relate to the regulatory framework and those that pertain to the supervisory framework.

The regulatory framework

Let me begin with some reflections on the regulatory framework.

Going back to the principles I highlighted earlier, I believe we should build upon the regulatory framework that already exists in the EU. Any improvement to the EU framework for financial supervision should first seek to fully exploit the potential of the existing framework. In this respect, the concepts and responsibilities of home and host supervisors and the framework for

consolidated supervision are well-embedded in the existing banking directives, and it makes a lot of sense for them to form the basis of the future approaches.

Indeed, the directive to implement Basel II in the EU – the so-called capital requirements directive – contains key provisions which will reinforce the role of the consolidated supervisor in relation to applications to use the advanced approaches of the new capital framework.

As I am sure you are all aware, these provisions will allow banking groups to make one application for approval in relation to the group as a whole, and will require the relevant supervisors to co-operate in trying to reach a common agreement on the application. Should it prove not possible to reach agreement within six months, the consolidated supervisor will have the power and responsibility to take the decision.

This is a significant development in the regulatory framework, giving the consolidated supervisor the possibility to take decisions with an impact that reaches outside the national jurisdiction. I am aware that the European Banking Federation believes that full consolidated supervision should be determined now as the ultimate objective for the EU regulatory and supervisory framework, but I believe that we have to approach this carefully, and see how the new provisions work in practice in this more restricted area.

I also think that it is important to recognise and respect the legitimate concerns of host supervisors. As I have already mentioned, the banking systems of some of the new EU member states are predominantly made up of incoming institutions. We should ensure that host supervisors are able to access sufficient information on the institutions operating locally and, where necessary, in relation to the wider group. The capital requirements directive also includes provisions in this respect and notes the need to take account of the significance of the institution in local markets.

Looking at the wider prudential framework let me mention two specific areas where the European Commission is currently reviewing the existing EU regulation.

The first area relates to deposit guarantee schemes. Although the deposit guarantee directive of 1994 was useful in setting common minimum requirements for national schemes, the current level of harmonisation is low, with different levels of protection and different structures in place across the EU. This is not only inefficient but may hinder further integration. As many of you will already be aware, the European Commission is currently undertaking a wide-ranging review of Deposit insurance arrangements, and I would encourage it to be ambitious in this respect.

The second relates to the work being carried out by the Commission with the aim of ensuring that EU financial services legislation and supervisory practices do not pose barriers to cross-border mergers and acquisitions. Consolidation processes should be market-driven phenomena that

respond to market needs, such as economies of scale, IT synergies, the benefits of diversification, access to a larger client base, etc. I think that supervisors do have a crucial but limited role to play in fulfilling their responsibility to ensure that banks are not taken over by shareholders that are not suitable on prudential grounds. But this is as far as we should go.

The Supervisory framework

Let me now turn to the supervisory framework.

I believe that we need to think in terms of a European system of banking supervision. I am not talking about a single European supervisory authority. I don't think the time has come for this, either at a conceptual or practical level. But rather, I think that we need to develop the existing institutional system for European banking supervision in order to ensure that all of the possibilities for co-operation and convergence are fully taken advantage of. The main policy objective at this stage should be to enhance cross-border supervisory co-operation in order for supervisory action to be perceived as unified.

This system should be built on four levels.

At the first level, we have the competent supervisor of each banking institution (whether this is the home or host supervisor in the context of the group), which will have to fulfil its responsibilities and accountabilities, on the basis of the powers and obligations it has been given by the national parliament and legislators.

The second level consists of bilateral co-operation between the supervisors of internationally active institutions. This has long been the bedrock of effective supervision in the context of increasing internationalisation, and will continue to be essential in the future.

Multilateral co-operation forms the basis of the third level. This is an aspect that has become progressively more significant in recent times, and which will grow in importance in the coming years. Both bilateral and multilateral arrangements will be increasingly necessary in the context of Basel II, where, as we have already discussed, the consolidated supervisor will be responsible for co-ordinating the supervisory process in relation to assessing applications to use the advanced approaches.

So far, I have been talking about what I refer to as "vertical" co-operation, in the sense it addresses the relationship between home and host supervisors in relation to specific institutions and groups.

But there is also a horizontal aspect that will be crucial for the future. This is supervisory convergence - the fourth level. Greater consistency in supervision is essential in promoting consistent approaches across borders, and thereby a level playing field. My view is that without convergence of supervisory practices across the EU, the consolidated or lead supervision model

seems likely only to lead to fragmentation, with different groups being supervised in potentially inconsistent ways.

This is why the work of the new Committee of European Banking Supervisors, or CEBS, is so important. This is the first time that the EU has had a committee that is formally charged with promoting co-operation between supervisors and convergence in supervisory practices. Danièle Nouy, who will speak shortly from her perspective as Vice-Chair of CEBS, is, of course, much better placed than me to talk about the work of this committee. But I think that CEBS has already made excellent headway, and will undoubtedly be the driver of progress in the future. And I'm sure that the industry will keep up the pressure to ensure that this is the case.

I believe that we need to combine these four vertical and horizontal aspects – together with enhanced supervisory transparency at all levels – in order to have the most effective and efficient system.

Conclusion

In concluding my intervention today, I would be the first to admit that the ideas I have mentioned today are not revolutionary, but I believe that an evolutionary and balanced approach is the best way forward and provides the greatest chances of success. The flip-side of the coin in this evolutionary approach is that the responsibility to deliver is greater. But if we do not succeed in meeting our objectives, we should not be afraid to explore other, more radical solutions. The costs of non integration is too high.

I would also like to re-emphasise that we have the possibility to make rapid and real progress in promoting an effective and efficient framework for European banking supervision. This should not only help us to achieve our goals within the EU, but could also promote greater convergence beyond the EU.

Allow me to put my Basel hat on for a couple of final comments on related challenges of the Basel Committee. At a more global level, we face the same consistency issue in the implementation of Basel II, and as I said, in this case, Europe can lead this process, we in Europe have more instruments to do it, and the example can be very helpful for the Basel process. This is the first and most important challenge of the Basel Committee in the next few years. As part of this process we will adhere to the published schedule for our fifth quantitative impact study. And I believe that we already have the tools at our disposal to deal with any issues that arise from the QIS5 exercise, or that arise during this period of implementation.

To be sure, a key element is not to add further details to Basel II, but rather to focus on achieving a quality implementation of the new Framework. Therefore, I do not anticipate any significant change

to the Framework during the period bankers and regulators are tackling initial implementation challenges.

But the main challenge is the cross border home host cooperation. On this point I would not underestimate the work and efforts that supervisors are devoting to this issue. One final related point. The staggered implementation, specially the timetable differences with EEUU raises transitional cross-border issues that will need to be managed through greater collaboration between the EU and US supervisors, but I can assure you that both sides are even more committed to this than before, and that our efforts will be redoubled in this respect. Ultimately, I hope that this commitment and effort will promote even more effective implementation.

A second related challenge is to enhance the cooperation with non-G10 supervisors. This has been one of the Committee's priorities and many significant steps have been taken and will be taken to improve the ownership of the standards and inclusiveness of the processes.

For example, the Committee has a long-standing working group that includes representatives from sixteen non-member countries, and we have increased our interaction with this working group. This past July, the Committee met in joint session with this working group in Krakow, Poland to discuss, among other things, Basel II implementation issues.

In addition, we encouraged non-G10 supervisory participation on working groups that are addressing issues related to validation and operational risk. I believe that this dialogue will, over time, foster greater consistency among Committee and non-Committee members. The Committee is therefore committed to heightening this dialogue and will consider further ways to promote consistency.

I noticed a quote on the cover page of the FBE's response to the European Commission's Green Paper on Financial Services Policy: "time passes quickly, we can not save it or buy it, but we can make it work and be fruitful". In the context of this speech I hope that you feel the past 20 minutes have passed quickly, have worked and been fruitful, and I wish you successful discussions for the rest of the day.

Thank you for your attention.