

European Retail Banking Markets Post-2005

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The View of CEBS in Retail Banking Issues

Introduction

I would like to thank the European Saving Banks Group, its President Charles Milhaud and Chris de Noose the Chairman of the Management Committee for organising this conference. The ESBG plays an important role in European retail banking and its position in local markets is traditionally strong.

Recent discussions at EU level have centred around issues like mergers and acquisitions, division of powers between home and host supervisor and the changes in reporting requirements. These questions are constantly brought up by the big cross-border banking groups but we must remember that local banks will be affected as well.

I would like to congratulate the ESBG on its active role in various consultation processes regarding the future legislation and implementation of new EU wide rules. The Committee of European Banking Supervisors' biggest priority right now is preparing for the implementation of the proposed Capital Requirements Directive which transposes the Basel II capital adequacy framework into EU legislation. .

In this regard we have published a consultation paper on Supervisory Review Process and received also your highly valued response to it. To my delight the comments received are in fact very supportive of our views. I'll take a more in depth view of the consultation process a little later in my speech.

The title for today's panel discussion is "Supervision in an Integrated Retail Market". Before I touch upon the supervisory practice in the Single Market I will try to assess the position of retail banking market in Europe. Can we really talk about integrated retail market? If not, how far away we are from achieving it and what are the main obstacles?

In the first part of my presentation I'll try evaluate the stage of integration in retail banking and the possible obstacles that are still hindering further integration. My second topic will be the treatment of banks by supervision authorities in different jurisdictions. I'll reflect on the present discussions about the role of consolidated supervisor and its affects on home-host issues. Third area of discussion is the convergence of supervisory practice and I will show you one very concrete example of what CEBS is doing to help banks to save time and money in their reporting to supervisors. And to finish my speech I'll describe the present consultation process on Supervisory Review Process – the Pillar II as it is known. But let me start we the view on retail banking.

Integration in retail banking

If we talk about banking as a whole we can see that markets have been changing, transforming and taking the shape of a Single Market. The number of pan-European institutions has been growing since the introduction of Economic and Monetary Union. The number of cross-border banking groups in the EU is in the region of 40 and at least five of them are present in ten or more EU countries. The pace of mergers and acquisitions has been slowing since the run up to the Single Currency, but there is no doubt that we are set to see more of this in the coming years. Changes in the legal environment (e.g., the European Company Statute) could also favour further developments in cross-border business.

European financial markets have already advanced greatly towards integration. Most segments of wholesale banking markets are almost fully integrated. But markets for retail banking services seem still to be very fragmented and local, in some cases with significant differences also within a Member State. While differences in overnight rates in the euro area vanished soon after the introduction of the euro, the “law of one price” – i.e. the sign of perfect integration – is far from ruling in retail markets. This is reflected also in the structures of banking, as wholesale banking is mostly based on branches while retail services are more often provided via subsidiaries.

The Financial Services Action Plan recognised the lack of integration in retail banking. Action Plan called for harmonisation in the field of customer information and recognised the lack of efficient procedures for solving cross-border disputes. We can ask, is our legislation on contract law or consumer protection, poorly conceived or patchy? Supervisors’ role in retail banking has also been questioned. Are there administrative barriers created by legislation or by the actions of national supervisors? These are the questions that the Commission has been trying to answer, both in the application of Financial Services Action Plan and in the following debate.

The Financial Services Action Plan was welcomed by all parties and several initiatives have been launched to speed up the integration of retail banking. But there are still many barriers that are blocking further integration and some of these barriers are natural and they can be not overcome by extensive regulation, deregulation or legislation.

First of all proximity of banks to customers is still very important. The bank has to “know its customers” but the customers also prefer service providers that they already know and who have an established reputation. Internet and electronic banking has changed the structure of banking in many countries but not as profoundly as one might have thought. Consumer confidence is a very relevant factor and familiar local brand names dominate the e-commerce in banking as well. The traditional distribution networks continue to play a major role in the retail business.

There are a number of other barriers to integration. Differences in language and culture would appear to be the fundamental ones. And we are naturally not very knowledgeable of each other's legal systems and complaints and redress arrangements. And of course there are different tax regimes, and tax arrangements certainly play a major role in deterring both cross-border sales and branching. It may be that some major restructuring projects will founder if the tax issues prove very costly and impede their progress.

We all have different structures of long-term savings and mortgage markets, which in many cases have deep cultural roots and customary practices which are not likely to be altered in the short run by legal changes. Other obstacles, such as obtaining secure legal title to collateral, can be significant. These factors tend to be more powerful at the retail level.

This list is long and most of the barriers arise from other than legislative reasons. But coming back to the question of supervisory practice, it is true that there are differences in implementation of EU legislation and supervisory practices which may affect the pace of financial market integration. The necessary compromises for the agreement on EU legislation may leave leeway for differences, however small, in national implementation. And then the supervisory practices adopted by national authorities may also be somewhat diverse. National circumstances, previous experiences or tradition and existing structures may also accentuate the differences.

Consolidated supervisor

The proposed Capital Requirements Directive adds new elements to discussion. The Commission is proposing to grant additional powers to a 'consolidated supervisor' in a number of specific areas of banking supervision to address the concerns of cross-border groups. You might ask if the introduction of consolidated supervisor is the right one or does it take too many responsibilities away from the national supervisors? It is my duty to try and answer these questions because supervisory practice affects all institutions big and small, local and international.

The large cross-border groups keep complaining about the general burden of dealing with many authorities instead of one. This is imminent when banks operate a network of subsidiaries across Europe. If all subsidiaries were transformed to branches the groups would need to talk to home supervisor only. But this might create even new problems, because local banks and branches of big groups would fall under different jurisdiction.

I think we can find a right answer to the legitimate requests of the industry by enhancing the role of consolidated supervisor as the Commission is proposing in the new Capital Requirements Directive. We are not talking about single European authority, a transfer of legal responsibilities to a lead supervisor or the introduction of supervisor of supervisors. The challenge is to enhance the role of the consolidated supervisor, via more effective co-operation between all the authorities involved in the supervision of a group, while ensuring the appropriate

involvement of the host supervisors and respecting their legal responsibilities. This is a very pragmatic, practical and tested approach. Cooperation and information exchange has been tested for years in the Groupe de Contact, which has now become CEBS' main working group. But we are now preparing even more practical guidelines to cover the complexity of home-host relation in constantly changing financial environment.

Consistency of application and level playing field across Europe are our common targets. The existing differences in local markets have to be taken into account, though. We must be cautious when making changes in legislation to be certain that they don't lead to distortions with national markets as local banks and branches of larger groups can be supervised by different authorities. This is why the enhanced role of the consolidated supervisor should go hand in hand with convergence in supervisory practices.

Convergence of supervisory practices

In CEBS we think that the only reasonable way forward is to further promote supervisory convergence, cooperation and information exchange so that home and host supervisor come together and coordinate their actions when interacting with institutions. Proximity still matters. It matters in retail banking. It matters in supervision as well. Local knowledge is an important asset.

Supervisors should be able to inspect and assess the banks that operate under their jurisdiction. The host supervisor is best placed to take an informed look at subsidiaries in its territory, and possibly to evaluate systemically important branches too. The home supervisor might even find this as better solution, if it delegates some supervisory tasks to the host. A supervisor of a subsidiary already has the possibility to delegate supervision to the supervisor of the parent. And a host supervisor already has powers to intervene if the home does not respond to legitimate problems.

We must also respect the subsidiarity principle. Some tasks are best done centrally, some are best done regionally, some are best done locally and some are certainly done best together. It is highly unlikely that full centralisation of all tasks is ever optimal.

We should be cautious in seeking or even trying to force retail market integration. National specificities exist. CEBS is working for convergence, carefully weighting the cost as well as benefits. Actions in the retail market area need to be based on a strong case.

The role assigned to CEBS is not to promote integration, but neither is it to obstruct integration. We must always be on our guard to ensure that what we do as supervisors – to underpin financial stability and ensure that banks operate in a prudent manner – does not act as a barrier to integration. But at the same time we must not lower our supervisory standards and safeguards in order to promote integration in retail banking, as we would be running a huge risk.

CEBS is working to promote a system that allows supervisors to fulfil their prudential objectives, while not hindering greater integration or imposing unfair

administrative burdens or costs on institutions that operate across European borders.

Our work programme is extensive and it is clear to us in the supervisory community that all these different angles need to be tackled before we can claim to have a well functioning and integrating EU market. I think we can achieve a lot with our soft law methods. Once the supervisory disclosure framework is in place it will put even more pressure on national authorities to contribute to convergence and help the banks understand better the approach of their supervisor and to highlight those differences across countries that may hamper financial integration.

In this current home-host debate we frequently come across sentences saying that the home country principle was built for a world in which the bulk of the activity was conducted in the home country and is not suitable for a situation in which a branch or a subsidiary is systemically relevant in the host country.

However, this is not true at all. We have gone back to look at the earlier papers to understand the historical background on home-host issues and the thinking behind the banking Directives. If you read the documents produced at the time, of the discussions on the second banking co-ordination directive, it is quite clear that the expectation was exactly to have a great deal of competition between jurisdictions. Banks were expected to relocate their business according to the most favourable treatment and provide services from this location throughout the Single Market.

If anything, the real question is why this only occurred so late and unevenly. It is likely that the answer is that banks find the other obstacles like culture, language, or taxes extremely hard to break through. Getting satisfactory solutions takes a lot more time than is usually thought.

To sum up, my key messages are that we are not starting from a zero base and that the banking sector is highly adaptable. CEBS has been established only recently, but I believe it has already shown its willingness and ability to move fast to meet the new challenges. As the market changes so we are willing to move too. We always need to bear in mind that new structures should aim to be more effective in prudential terms and more efficient in cost terms.

Reporting requirements

Let me give you an area where CEBS is making concrete progress and converging practices. I'm now referring to reporting requirements.

Banks have complained that when they go cross-border they have to report to a number of different supervisors according to different formats. This has a significant impact on their compliance costs. The reporting requirements themselves are surely sound, but I am not clear that all of the differences between national requirements can be well justified. And this is not only a cost issue. The supervisors should adopt a common approach to promote consistent treatment of institutions as a safeguard to level playing field. And the availability

of similar information at national authorities is a pre-requisite for an effective exchange of information.

CEBS has now taken the initiative to develop a common reporting framework for institutions to minimize their administrative burden and save on compliance costs. CEBS has been working on this project over the last few months and our members are making informal contacts on national level with industry to get their initial views before publishing the formal consultation paper. CEBS will start a formal consultation process to achieve first a common solvency ratio reporting framework for banks and investment firms.

Implementation of new international accounting standards and the Capital Requirements Directive provide the EU with a unique opportunity to harmonise the framework for supervisory reporting, as all authorities will need to develop new reporting requirements. Some smaller banks have voiced concern that all this is done on behalf of large cross-border banks, while they will have to bear the costs of switching to a new system. But with the Capital Requirements Directive changes to the present reporting system will have to be introduced in any case, so we have the opportunity to promote greater convergence in this area without creating additional costs. And I can assure you that common reporting framework will benefit all market participants. Common reporting will address the demands of the industry and make it easier for supervisors to co-operate and exchange information and reduce the differences in the implementation of the new solvency rules.

It is CEBS intention for this reporting framework to apply in all Member States. The work is currently primarily focused on regulatory own funds and Pillar I capital requirements, credit risk, operational risk and market risk. The reporting framework does not cover areas such as liquidity, large exposures and credit registers.

The proposed technical solution does not affect existing reporting systems. It should be noted that the recommended solution that takes full advantage of the data model's functionality is the XML-based XBRL protocol. In a few months a complete coding with required templates will be provided for this reporting framework. CEBS is providing all this free of charge to keep the installation costs as low as possible. During the next few weeks national supervisors have the opportunity to informally discuss with you and obtain your initial views. This discussion, as I already mentioned, does not replace the formal consultation process which will take place year.

Supervisory Review Process

Now - as a last part of my presentation - it's time to take a closer look at one of the central pieces of our present work – the Supervisory Review Process. The first round of consultation has ended and the analysis of the responses is under way. It seems that a second round of consultation will be conducted during the spring 2005.

It has been a long process and a very important one. Our first consultation paper was developed over several years, during which EU supervisors talked to their national industries to get a clear understanding of what banks and investment firms wanted. We decided to release the paper already before the text of the Directive was finalised because we considered it important to consult interested parties at an early stage in order to encourage dialogue and to promote transparency between supervisors and financial institutions.

CEBS is working hard on the development of common principles for the implementation of the supervisory review process. We are aware of the industry's desire to see EU-wide implementation of this important piece of the supervisory framework. Our intention is to get the consistent approach that would be suitable for all of us.

Our consultation paper sets out principles for the overall Supervisory Review Process and its two main complementary elements: the Internal Capital Adequacy Assessment Process – which is the firms' own evaluation of their capital needs - and the Supervisory Review and Evaluation Process - the supervisors' process to evaluate firms. The paper describes what supervisors will expect from institutions in their assessment of the adequacy of their financial resources. It also contains principles on the supervisory authority's obligations under Supervisory Review and how these might be performed.

We received sixteen responses to the paper. I am pleased to tell you that there seem to be only few areas where we still need some additional work and clarification of terminology or definitions. At the same time we are urged not to include too many details and definitions because overly prescriptive approach wouldn't be appropriate. There is a need to maintain certain flexibility that both supervisors and credit institutions need.

From the responses we understand that there is agreement that the Internal Capital Adequacy Assessment Process should be owned by the financial institution itself. And that it is for the institution to define, develop, and manage its Process. We all support also the concept of proportionality which is very important to smaller institutions. We understand the demands that CEBS should bring more clarity regarding the criteria which should be used to apply the proportionality principle. It is understood by all parties the principles – later to be turned into guidelines – are intended to enhance the level playing field in the EU under the new capital regime.

All of us agree on the importance of risk based framework and capital planning. The new Basel framework emphasised the importance of capital planning but also the importance of management responsibility, corporate governance and other qualitative aspects of risk management.

We are moving towards an agreement on the key issues but there are still differences remaining in our views. One topic is the scope of the Supervisory Review Process. Our consultation paper recognises that the firms' process and the supervisory review and evaluation are separate processes. The first is yours

and the second is ours. But we are also proposing that the two processes should work within a wider Supervisory Review Process. In practice they are closely intertwined and there will be a close interaction between them. It will then generate an important and necessary dialogue and feedback mechanism, which quite rightly might still need some more clarification and guidance.

In addition there are some other areas we need to revisit and look more closely. Definition of risks - especially reference to non-material risks - will need clarification. Annex B of the Paper contains proposals for definitions of a series of risk factors. The industry's position on this is quite clear - it is impossible to cover all possible risk factors and CEBS should stick with the material risks of the Basel Framework. This will certainly be reviewed in the process.

The industry has also expressed some concern about the possible encouragement to make greater public disclosures of their internal process. From their perspective this could include competitively sensitive information – so it should not be applied. I guess this is a valid argument and have to be assessed accordingly. But I must stress also the importance of general disclosure requirements in the proposed Capital Requirements Directive – the Pillar III of Basel framework. Transparency and market discipline are central part of it and institutions must disclose their risk management objectives, policies and risk exposures. How far we want to go in disclosing internal processes remains to be seen.

You will be able to express your views again during the second round of consultation that will start in the spring of 2005. You can also take an opportunity to contact the industry's representatives who are members in our Consultative Panel.

To conclude my presentation I would like to make some final remarks.

Conclusions

CEBS' objective is to actively contribute to convergence of supervisory practice and ensure level playing field. Cross-country differences in legal and administrative systems still exist, and in operational and cultural aspects mean that supervisory practices will not converge overnight. We should also keep in mind that retail banking in Europe is still largely conducted on a domestic basis by domestic banks, and we have to ensure that our approaches reflect the realities of the system. We can therefore only go step by step, but I can assure you that we aim to do this in a consequent and straightforward way, and that we are completely committed to the task ahead.

Thank you for your attention.