Conference on supervisory convergence in Europe

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How to deal with emerging pan-European financial institutions

The current landscape

First I would like to asses the scale of the issues we are discussing. How many emerging pan-EU institutions are there, how many can we expect in the medium to long term? I would also like to touch on what they will expect from their supervisors, their legislators, and their central banks. I mention these three constituencies, gathered here today for this conference, for a reason: I think our individual contributions to this debate can only take us so far, in terms of the legal structures, prudential safeguards, and financial stability. Only by addressing the whole picture can we make sure that we have a coherent and appropriate regime within which our financial services industry can be efficient, well managed, and profitable, to deliver a sound banking in which the public has confidence.

Tommaso Padoa-Schioppa has given us a very clear overview of the state of EU banking. I agree with his analysis that these changes are real and happening across the EU. At the last count in 2002 there were about 40 cross-border banking groups in the EU area. On average they have significant presences in five or six EU countries, but only five of them are present in ten or more EU countries. The pace of integration and M&A activity was high in the run up to EMU but has slowed a little in recent years, but there is no doubt that we are set to see more of this in the coming years.

The cross-border component in banks' assets has become more important. Cross-border securities issued by non-banks equalled more than 40% of total securities holdings and cross-border holdings of interbank loans amount to 30% of total interbank loans (2003). The share of five largest institutions in the total bank assets amounted to 53% in the EU in 2003, 80 % in the new member states. Merger and acquisition activity, both domestic and cross-border, in terms of value was at the highest level in the run-up to and the early years of Monetary Union (more than €100 bn in 2000). Since then it stabilised at under €40 bn. The share of non-domestic branches and subsidiaries in the banking assets of EU stood at around 20% in 1999 and almost 25% in 2003. These are mostly located in the UK, Germany, Scandinavia, Spain, and the Netherlands.

What is driving pan-EU institutions?

I would flag the following factors driving the industry to consolidate:

The key driver must be the need to achieve ever better economies of scale and access to capital. There is no doubt that within the industry there is a pressing

need to access lower cost capital and rationalise duplication. This is leading to a great deal of consolidation, outsourcing, and in-sourcing (which I mean that functions, such as the back-office, of large groups are being centralised to in-house specialists in one or two countries). The drive to reduce the cost of capital is leading to bigger and better rated banks with larger asset bases that are better managed and able to offer a wider range of services. In order to boost their ratings institutions are also seeking to diversify their risk portfolios.

EU banks do not sit in a vacuum. They face intense competition from very large global firms with even larger capital bases. The leading institutions are pressing hard to match these big - mainly US - banks to compete at the global level.

Some institutions are now reaching the limits of national consolidation in many Member States. For a complex number of reasons, including the obvious concerns of national competition authorities, it would appear that some big banks can only grow by expanding cross-border.

These institutions are also seeking access to wider customer bases, to tap investment and savings in different countries. As competition drives down margins these institutions must also strive for bigger volumes.

It is possible that the potential for regulatory arbitrage could drive some decisions, although the evidence for this is not obvious. The single market aims to ensure that all supervisory authorities are equivalent and adhere to the same rules in a consistent way. But we can never rule out that institutions might feel that some jurisdictions are more open to growth or operate a more liberal regime than others.

And of course I must mention new legislation that is often cited as driving some big upheavals, i.e. the European Company Statute, that may be used by large groups to restructure their subsidiary structures into branches.

What is blocking them from moving further/faster?

The conference theme contains a presumption that legal and supervisory structures are the main barriers to integration. But we need to review whether these indeed are barriers, and if so, whether they are the main barriers and how could they be removed.

The introduction of the euro was designed as a key element in completing the single market and ensuring a single deep and liquid capital market. It is true that on the wholesale side there has been an acceleration in integration in euro area countries, in terms of prices (as seen in interbank rates) and in volumes of cross-border flows. Similar integration was apparent in the capital markets even earlier. But there is an interesting question over why integration in retail banking has not accelerated since the introduction of the euro.

Key barriers

Let me start with my assumption that there are a great number of barriers to integration. I think this must be true, empirically, given that integration is slow and the industry is very vocal in its complaints. Let me list the main ones that come to mind:

I suspect there are some deep natural obstacles to cross-border trade in financial services. Differences in language and culture would certainly appear to be the rather fundamental ones. And we are naturally not very knowledgeable of each other's legal systems and complaints and redress arrangements. Proximity in retail banking is probably essential: these are usually customer-driven businesses and a bank's management needs to have a deep understanding of its customers and markets.

Some of these barriers may be more artificial. The lack of integration may be partly attributable to legal obstacles. 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, 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. The high cost of retail cross-border payments is a familiar issue. Other obstacles, such as obtaining secure legal title to collateral, can be significant. These factors tend to be more powerful at the retail level.

There is also the issue of EU competition (anti-trust) policy. Personally I would be very interested to know in detail the views of the competition authorities at the EU level. What is their approach to M&A activity, the size of EU market share and in what configuration? Perhaps the chairman of this conference can address this big question to the Commission?

Is our legislation on, for example contract law and consumer protection, poorly conceived or patchy? This is a question that the Commission has been trying to address, both in the FSAP and the post-FSAP debate. We have some answers now from the expert Forum Group reports and industry players. I will return to this theme in a moment, but my initial answer is that probably – and despite all our efforts – it is not perfectly joined-up, either within sectors or between sectors. If Tommaso Padoa-Schioppa is right, then these gaps will become ever more apparent as large banking institutions and conglomerates seek to widen their cross-border operations. Their efforts to bridge these gaps are driving up their costs. They are signalling loudly that they see rising costs and contradictions.

Then we turn to the differential implementation of legislation. This is a well known problem. As representatives of finance ministries, I am sure many of you here today will recognise this situation. Despite our best intentions we often agree deliberately ambiguous EU legislation in order to get the necessary compromises. And then the national authorities implement it in slightly different ways. National circumstances and existing structures may also accentuate the differences.

I would also highlight different supervisory practices and national requirements. Each Member State has of course its own national competent authority (or authorities) for banking. This reality means that large cross-border institutions have to live in a multi-jurisdictional world. Different supervisory practices may also arise for very sound reasons, such as making sure that supervisory practices fit with the rest of civil society's rules and experience. There are many issues here, but I would like to give one a concrete example: 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 huge 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 finally, I cannot ignore the fact that several banks have complained to finance ministers about the protectionist use of regulatory and supervisory tools, even harmonised ones.

This is a long list 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 often wonder whether integration is like building and operating a motorway. There are bridges, stretches of road, on-ramps, traffic control systems, and driving tests. Individual parts of the system can be beautifully conceived and perfectly executed. But the traffic cannot move smoothly until all the pieces work and fit together. If only some of the traffic lights are working or some of the bridges are not connected to roads, or some drivers do not know the rules of the road, then the system as a whole must actually work against integration. It will reinforce isolation and keeps activity localised. At a minimum we need to agree on clear legislative concepts, and common implementation. In my motorway example, we need a coherent traffic management plan that ensures the various parts are well made and are joined together.

Most of these barriers I mentioned are probably the responsibility of others, for example, EU legislators, finance ministries, the financial services industry etc.. It is not my business to go into them here. But on the financial motorway, supervisors are mainly responsible for licensing the drivers and policing their

actions to protect the overall infrastructure. Others need to make sure they have done their planning and building too.

The last two possible 'barriers' I mentioned are within the remit of CEBS. I first want to address the specific charge of protectionism. I am clear, and my committee is clear, that it is not the role of CEBS 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. We fully agree that protectionism is unacceptable. All protectionist actions and attitude should be identified and sanctioned, for example by the European Commission and the EU Courts. It may be that CEBS could also exert some peer pressure to discourage protectionism, but it clearly has no enforcement or legal powers. The same attitudes and polices should apply to third countries which have opened their markets for take-overs by European institutions.

At the same time we would argue that EU regulators and supervisors should be very careful. We must not throw the baby out with the bathwater. The tools for any institution to challenge supervisory decisions that are discriminatory, anti-competitive or anti-commercial, between Member States are already enshrined in the Treaty and legislation. If these rules need to be reinforced, that is sensible. If, in order to work properly in banking, they need to be more transparent and expose the thinking behind supervisory decisions, that is also sensible. But if, in order to tackle a misuse of the powers by some authorities, we decide to lower the supervisory safeguards against persons who are not fit and proper, then we would be running a huge risk.

For example, supervisory authorities cannot and should not be forced to accept as a significant shareholder or manager anybody who has been convicted for fraud, murder, or other serious criminal activity. Banking is based on confidence, and if there is a well-founded suspicion that somebody is not fit and proper, he or she should not be involved in the sound and prudent management of the bank. The supervisory authorities should have the power to refuse authorisation.

What practical work are we doing in CEBS to ensure convergent supervisory practices?

I now want to turn to the barriers that may exist as a result of different supervisory practices. How are we going to deal with the problems of pan-EU groups? What is CEBS doing to deal with these?

In EU terminology CEBS is what is known as a Level 3 committee. This means that we sit under the formal EU legal structures at Levels 1 and 2, and that we largely take the legislation that is handed down to us. One of the key complaints about barriers to integration is that, whatever the formal legislation, the national practices are faulty or different. One of the key tasks of CEBS is convergence of

supervisory practice within the new rules. We are trying to draft sets of standards and guidelines for supervisory practice that we intend to be applied consistently by all national authorities. In this way, we can ensure that banks face a more level playing field, and that pan-European banks are subject to a cost-efficient supervisory system.

Basel II is a huge opportunity to drive more co-ordination and convergence of approaches. The proposed Capital Directive is a good example of what we do at level 3. Just last week CEBS discussed its work programme. It is our intention that it will be further commented upon by our Consultative Panel and then published. It will show that CEBS is dealing with the key issues for integration, i.e. the supervisory review process (also known as Pillar 2 under Basel II), the validation of the advanced models (under Basel II), and the reduction of national discretions in the Capital Directive.

The Capital Directive will be one of the first Directives to be delivered with levels 1, 2, and 3 presented as a full package. We are working to deliver common supervisory practice and a common interpretation and implementation of the legislation at EU and national level. Under the supervisory review process we are aiming for a comprehensive compendium of guidelines by end-2005.

I mentioned a moment ago that banks have complained about the reporting requirements they have to make to a number of different supervisors according to different formats, with an impact on their compliance costs. We are trying to develop a common framework for the reporting of the capital ratio, including also the use of a common technological platform. Such a framework should reduce the reporting burden on credit institutions and investment firms, improve the co-operation between supervisors and help us move towards a “level playing field” across the EU.

Information exchange is one of the main items in the mandate of CEBS. A great deal of information exchange is already done in bilateral contacts between members of CEBS, or through the Groupe de Contact of national banking supervisors (CEBS’s main working group). We are performing a gap-analysis to see in which areas the information exchange could be further enhanced. Work is already being done, for example on developing guidelines on the update or further integration of MoU’s for the period after the Capital Directive enters into force. The secrecy regulations in the directives will shortly also allow more information exchange with central banks and with ministries of finance, as well as between supervisors. CEBS is looking at working methods and guidelines to stimulate an optimum information exchange regime, taking into account the conditions which will still be in the directives as well as effective and efficient working procedures.

Home host issues

Now I want to turn to the current debate on home-host supervision. This takes us into a very difficult set of inter-related issues, which go right to the heart of how supervisors interface with the single market. This debate needs to address all the angles, to ensure that what is agreed is coherent and workable, both within sectors and between sectors. Going back to my earlier analogy, I do not want to see changes to the motorway signage without us all understanding how this will affect the direction of traffic and the capacity of the road.

Let me start with an assertion: the consolidated supervisor model works for prudential supervision. I say because it gives us legal certainty, it is a well understood and long standing piece of legislation, and it logically aligns responsibilities to the commercial reality of the bank, through the home supervisor and country of incorporation.

I fully understand that many in the industry are raising real issues and have genuine concerns. Of course these institutions want to reduce costs and their administrative burdens. The big banks want to be able to grow, to meet global competition. They have duties to their shareholders and customers. More efficient banking benefits the economy as a whole, when it allocates capital more efficiently and translates savings into investment capital. We need to see what can be done to address these concerns. But also we need to bear in mind the responsibilities of supervisors, our prudential concerns and our whole entity perspective.

From a supervisory perspective we want to work within a pragmatic regime that fulfils the following requirements:

- it should maintain legal certainty;
- it should deliver positive results in the short term, and an expectation that more results will become ever more visible over time; and
- it should be based on existing structures.

We are not starting from scratch. Whatever we agree should reinforce the concept of the home supervisor. The main advantage of starting here is that we can make fast progress and not get stuck in structural debates (which we all know can take years at the EU level).

I would like to comment at this point on the calls for a new regime based on the concept of a lead supervisor. The terminology is confusing and is often used in different ways by different people. If we are talking about a “single point of entry” or “single interlocutor” for international institutions, with the home country supervisor in charge of everything, I think this is unrealistic, and does not meet the requirements I have just set out. If we are talking about building on the concept of the consolidated supervisor, which is the approach proposed in the Capital Requirements Directive, then I think we are moving along the right lines.

The proposed Directive takes us into new territory on the respective roles of home and host when we are talking about model validation. CEBS has taken up this challenge. We are now working on the application of these provisions to ensure that they can be made to work in practice. We hope that this can be fleshed out early next year to explain to industry what is expected.

But let us take a moment to reflect to on the bigger themes that are currently under discussion. 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 favorable 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 I mentioned above (e.g. tax, culture etc.) extremely hard to break through, and that getting satisfactory solutions takes a lot more time than is usually thought.

Nevertheless, there is a perception that there could be a conflict. On the one hand we have the mandate and accountabilities of the authorities, which are set at the national level. On the other hand, we need to take account of the scope of the interests that are affected by the conduct of their tasks, which is cross-border and often EU-wide.

If this is really an issue (and it was not considered such at the time of the building up of the Single Market) there might be two possibilities to address it:

The first is to realign mandate and market scope by creating a single EU authority. This might be a single banking authority or a single cross-sectoral body.

The second solution might be to align the mandates of the national authorities to make them meet the scope of EU-wide interests. This could be done by introducing an EU element into the powers of (some) national authorities. The Level 3 committees might have a role, through peer review, ensuring that there is a level playing field between the national supervisory authorities and that they all

adopt common approaches. We also might include third countries which have opened their markets to take-overs by European institutions.

There is also a good deal of untapped flexibility in the current legislation to allow us to co-operate and manage a more sensitive EU regime. For example, home supervisors may delegate responsibilities to others. But we have already conducted a survey and discovered that this provision has never been used. 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. I would argue that re-reading the Directives could be a very fruitful area of research, before rushing ahead to overturn the whole current regime.

Some final comments

I want to end with some comments on the role of the host supervisor. This role must be real and substantial for three good reasons:

proximity matters in supervision. 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 look at systemic branches too. The home supervisor might even find this is a better solution, if it could delegate some supervisory tasks (but not the authority) to the host;

we must also be mindful of the subsidiarity principle. Some tasks are best done centrally, some are best done regionally, and some are best done locally. It is highly unlikely that full centralisation of all tasks is ever optimal; and

as I noted at the start, there are systemic branches in many Member States and the number is likely to grow over time. I find it hard to believe that supervisors, central banks or finance ministries could (yet) accept that they might have no role whatsoever in the supervision of truly systemic institutions operating in their economies.

What is the role of CEBS is all this? The Committee is neither a home or host authority. But its members are all the home and host authorities in the EU and EEA. We see the issue from all sides and are working hard to come to solutions that work for everyone.

To sum up, my key messages are that we are not starting from a zero base and that the banking sector is highly adaptable. We have a good history of moving fast to meet new challenges. As the market changes so we are willing to move too. But we always need to bear in mind that new structures should aim to be more (not less) effective in prudential terms and more (not less) efficient in cost terms.