Wolfgang Duchatczek

Wolfgang Duchatczek
Vice Governor
Oesterreichische Nationalbank

Introductory Remarks[1]

Financial institutions currently face a number of challenges; among these, the implementation of "Basel II", the new capital adequacy rules for banks (and, within the EU, for investment firms as well) is probably the most obvious.

As of 2007, Basel II will start replacing the so-called "Basel I" regime, that is the current Basel Capital Accord dating from 1988. Basel II will take into account changes in risk management practices and reflect the sophistication and complexity of today's financial transactions and products. The new three-pillar approach, comprising minimum capital requirements (Pillar 1), the supervisory review process (Pillar 2) and specific disclosure requirements aimed to encourage market discipline (Pillar 3), will further strengthen the stability and soundness of the banking system by promoting stronger risk management practices, introducing more risk-sensitive capital requirements and covering risks more comprehensively.

After drawing up numerous consultation papers and impact studies, in June 2004 the Basel Committee on Banking Supervision (BCBS) adopted a revised capital adequacy framework. At the EU level, the discussion process is continuing: In December 2004, the

[1] *The author wishes to thank Karin Hrdlicka and Michael Würz for their valuable comments on this contribution.*

Ecofin Council unanimously agreed on the general approach taken toward the proposed Commission Directive, and in the European Parliament, the Committee of European and Monetary Affairs has just started its own debate on the issue. However, there is a good chance that the so-called Capital Requirements Directive (CRD) will be adopted in the first reading in September.

In any case, this extensive and intensive dialectic process of putting forward proposals, considering, and – where justified – incorporating, received comments and taking into account the results of impact assessments suggests that the observation by the ancient Greek philosopher *Aristotle* that "Law is mind without reason" does not hold true for the regulations laid down in Basel II and the CRD. Indeed, as already noted, there are good reasons for introducing a more refined regulatory capital regime, not least the increasing awareness that the broad-brush approach to risk measurement which characterized the Basel I regime gave banks ample room to circumvent the rules and to engage in regulatory arbitrage.

Basel II, as a more general regime of banking regulation, is relevant from both a micro- and a macroperspective, given the close link between banking stability and systemic stability and the potential effects of capital adequacy rules on the economy (lending to SMEs, procyclicality, etc.). Accordingly, both perspectives have to be considered, and central banks have therefore been heavily engaged in developing the new capital adequacy framework. Moreover, the European Commission's proposed directive for transposing Basel II into European Community law likewise contains a specific provision stating that the European Commission has to periodically monitor whether the directive has significant effects on the economic cycle, and that the European Central Bank has to contribute to these monitoring activities.

With a view to Basel II implementation, substantial investments are currently being made by the banking industry and preparations are being carried out in an extensive dialogue between banks and their supervisors in order to ensure a smooth transition to the new regime. In this sense, the term "micro-challenge" used in the title of this session certainly needs to be put into perspective.

However, besides Basel II, there are a number of additional aspects posing challenges to financial institutions. For example, on May 3, 2005, the "Green Paper on Financial Services Policy," in which the European Commission sets out its preliminary financial services policy priorities for the next five years, was published. Even though the European Commission's focus will be on implementation and consolidation, it is also considering several new targeted legislative initiatives. In particular, the area of retail financial services has been identified as requiring specific attention in order to make the vision of an integrated financial services market a reality for EU citizens. It is obvious that any initiatives in this area would very likely have a substantial impact on the institutions involved. Moreover, some of the concepts considered, e.g. the introduction of a "26th regime," in which optional European standards would be designed for cer-

tain products in parallel to the existing national rules, probably leave more questions than answers.

Moreover, regulatory developments are not the only source of micro-challenges for financial institutions. Against the background of less favorable market conditions and the search for profits, strategy, competitiveness and efficiency considerations have gained importance over the past few years, leading major banking groups to rethink their internal organization structures. The main features of this reshaping include the increasing centralization of certain functions (e.g. liquidity management and risk management) at the group level on the one hand and the outsourcing of other lines of business, particularly support activities, to nongroup companies on the other hand. At the same time, several banking groups have begun to refocus on their core business activities, reduced their staff and downsized their distribution networks in order to create shareholder value and increase their efficiency. Moreover, it is also argued that there may be scope for another wave of consolidation.

These examples of micro-challenges are only intended to give a preliminary idea of the topical issues for financial institutions. The panel discussion will provide the opportunity to further reflect on these issues from the perspective of supervisors and central bankers, academia and the industry by addressing, among others, the following questions: What are the main challenges for the financial industry, and how are they impacting on institutions' risk profile, their resources,

strategies and business models? How can financial institutions best respond to these challenges? Finally, what role are supervisors expected to play in this respect? ❧