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Micro-Challenges for Financial Institutions

Let me first thank you for the invitation to participate in this panel discussion of the Economics Conference.

We have heard a lot about Basel II – about the importance of economic capital and how Basel II may affect the way monetary policy influences some key financial and real variables.

Using a somewhat different starting point in my contribution, I would like to focus on three different micro-areas. As a representative of a supervisory authority I will first illustrate the new challenges for supervisors; second, present the main challenges for banks resulting from Basel II; and third, point out what we can expect from the post-FSAP period.

With regard to the new challenges for supervisors, I see more and more that regulators have to implement an integrated approach in supervision. Why is it so important to choose an "integrated view"? Let me illustrate this with a few points:

- Financial markets are becoming progressively integrated and increasingly complex;
- Cross-border systems of trade are emerging;
- There is a burgeoning supply of financial services across sectors – insurance companies offer loans or substitutes to loans; banks are a powerful distribution channel for

insurance policies – and these are only a few examples;
– There is disintermediation on the one hand as well as an increase in cross-sectoral interlinking among companies – up to big financial conglomerates – on the other hand.

As a consequence, which conclusions have to be drawn? I believe that regulators have to take care of a level playing field – not only across national borders, also across sectoral borders.

Moreover, regulators have to build up a supervisory framework that gives flexibility to regulate a permanently changing financial market and to avoid supervisory gaps. In the end, regulators and supervisors have to cooperate internationally in order to develop and enforce common international standards which will enhance the efficiency and integration of financial markets. In that context, the general conclusion is that the concept of an integrated supervisor meets these challenges best.

Let me come to the second part of my statement and allow me to briefly stress the main challenges for banks resulting from Basel II.

First, banks must implement new core processes in order to fulfil the Basel II requirements. The implementation of new processes is not restricted to risk management departments. It affects and encompasses the whole credit approval process throughout the whole banking organisation. For example, rating results (rating grades, PDs) as used for the calculation of IRB parameters must be used as a main input for internal risk management and the credit decision.

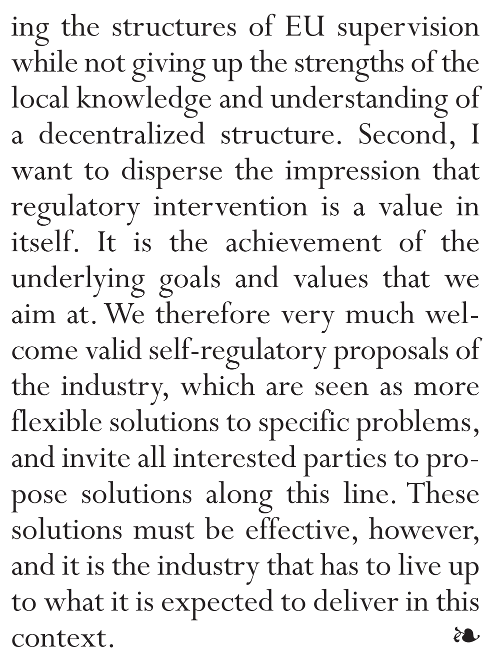
Second, in order to use credit risk mitigation techniques to gain reductions in capital requirements, demanding operational requirements must be met. An example is the requirement that the bank has to ascertain that real estate property is adequately insured. Therefore the new framework places risk management at the centre of the bank's strategy and requires managers to understand the drivers of risk inherent in their business.

A further main challenge for banks are the requirements arising for banks from Pillar 2, which shall not be underestimated. Pillar 2 requires banks to assess all relevant risks and relate the risks to their economic capital. This is the so-called *internal capital adequacy assessment process* (ICAAP). Unlike the regulations of Pillar 1, the rules of Pillar 2, do not prescribe how risk has to be calculated. Pillar 2 only prescribes which risks have to be considered in the assessment, if relevant (e.g. interest risk in the banking book, residual risk, concentration risk etc.). Apart from the requirements related to the ICAAP, Pillar 2 states requirements concerning internal procedures and internal control mechanisms (e.g. governance arrangements, organisational structure, lines of responsibility). These internal procedures shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities. It is in the first place the bank's job to define what this means for its own procedures and control mechanisms. But it will be checked by the supervisor, too.

Pillar 2 as a whole is designed to give banks and supervisory authorities room for flexibility and the opportunity to implement the rules in a proportionate way.

So far, I have highlighted the new challenges for supervisors and the key challenges for banks resulting from Basel II. Looking ahead in regulatory development, I will devote the last part of my contribution to what we can expect after the intense FSAP period with its 42 areas of re-regulatory activity.

The micro-challenges of Basel II and of other recent directives are high, to say the least – not only in their sheer quantity, but also in their qualitative dimension. While the industry is complaining about the cost of regulatory regimes, it is at the same time concerned about the still high fragmentation of financial markets in Europe. The irony of this situation that the best efforts to deliver the necessary regulatory framework for a financial internal market, accommodating state-of-the-art risk management systems and innovative product markets, now seem to have provoked regulatory fatigue. This is the reason for a thorough examination of the state of affairs, as laid down in the Green Paper of the European Commission on the 'post-FSAP agenda'. What challenges do we have to face in the post-FSAP period? In that context many topics may be discussed, I would like to briefly underline two issues: First, I support the message of the Green Paper: let the current, just recently set framework of integration, cooperation and coordination work out first before possible next steps are taken into consideration – both as regards the regulatory environment and as far as the current EU supervisory system is concerned. We understand the need to accommodate the demand of EU-wide or even global players to streamline their regulatory contacts and to provide a level playing field across sectors and jurisdictions. And it is this goal we have been aiming at in reform-



ing the structures of EU supervision while not giving up the strengths of the local knowledge and understanding of a decentralized structure. Second, I want to disperse the impression that regulatory intervention is a value in itself. It is the achievement of the underlying goals and values that we aim at. We therefore very much welcome valid self-regulatory proposals of the industry, which are seen as more flexible solutions to specific problems, and invite all interested parties to propose solutions along this line. These solutions must be effective, however, and it is the industry that has to live up to what it is expected to deliver in this context. ❧