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Toward Supervisory Convergence in Europe: A National Perspective

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Es gilt das gesprochene Wort.

Ladies and Gentlemen,

The Chinese word for ’crisis’ is said to be composed of two characters – one representing danger and the other representing opportunity. In the course of the ongoing financial turbulence, we can see both danger and opportunity arising for the global financial system. As recent events have shown, problems that occur within a specific market segment can cause severe turbulence also in other markets and can quickly spread to different jurisdictions in an increasingly globalized financial world. Both the private and the public sector have taken rapid and coordinated measures to face this danger. At the same time, we find that opportunities arise in these difficult times, too: for instance when healthy institutions take over banks in distress, but above all, they arise in the field of supervisory cooperation and convergence.

This is the topic of my speech today: “Toward supervisory convergence in Europe: a national perspective”. First I will assess recent developments in the European banking sector and the ongoing financial turmoil, thus setting the stage for the second part of my speech, where I will make some observations, and draw conclusions, regarding the future of financial regulation and supervisory convergence in Europe.

1. Developments in the EU banking sector

The European financial landscape has experienced considerable structural change in recent years and is undergoing major modifications in the wake of the current financial turmoil. These developments were spurred, among other things, by the liberalization of capital flows and trade in financial services that increased the interdependence of economies and financial markets.

Other factors that created new opportunities and challenges in the financial sector were sophisticated and affordable information and communication technologies coupled with rapid financial and technological innovation. The introduction of the euro marked a milestone in financial integration in the euro area: The adoption of the singlecurrency has eliminatedcurrency risk for euro area members, and it has increased borrowing and investment opportunities. New regulation such as the Capital Requirements Directive (CRD) implementing the Basel II accord for credit institutions and investment firms, the new solvency requirements for insurance undertakings (Solvency II) and the creation of the Single Euro Payments Area (SEPA) have also contributed to substantial development in the European financial landscape.

As a result of these factors, the level of financial market **integration**[1)] in Europe has increased significantly in recent years. However, regarding the degree of integration, substantial differences remain across the various market segments. The euro area money market as well as the government and corporate bond markets, for instance, are characterized by a relatively high degree of integration. The euro area equity market’sintegration has progressed even more rapidly than on a global scale, although local shocks still play an important role. Regarding banking markets, the euro area interbank and wholesale markets as well as capital market-related activities have become increasingly integrated, whereas the retail banking markets continue to be highly fragmented due to persisting differences in national economies, institutional factors, financial structures and consumer preferences.[2)] As is well known, fostering the convergence process in the retail banking market is one of the major objectives of the European Commission’s financial services policy that is supported by numerous regulatory and legal reforms.

The trend toward **internationalization** of EU banking groups is evidenced by rising cross-border activity as well as increasing cross-border mergers and acquisitions, although domestic consolidation has still prevailed in the EU over the past years.

Overall, the cross-border banking landscape in the EU shows substantial differences regarding international activities – especially with respect to the twelve “new” EU Member States (EU-12):[3)] While foreign entities accounted for approximately 70% of total banking assets in these countries in 2007, it was 28% only in the EU-15 and 29% in the EU-27.[4)] In Austria, foreign entities accounted for some 27% of total assets in 2007 due to the fact that some large credit institutions are foreign-owned. At the same time, Austrian banks are very active in Central, Eastern and Southeastern Europe; their market share in this region came to more than 15%, and even to approximately 23% excluding Russia. With regard to the cross-border provision of financial services in the euro area, holdings of nonbank debt securities and interbank loans as well as interbank deposits have predominated in recent years. Other banking activities such as cross-border lending to nonbanks or cross-border nonbank deposit-taking are becoming more important, although they still remain on a relatively low level.

Recent structural changes in the banking sector entail also increasing **market concentration,** given the creation of large – and often complex – banking groups. The degree of concentration can be measured by the largest institution's market share, which increased to 44% in the EU in 2007. The respective figure for Austria was 43%. **Intermediation** in the EU countries has strengthened as well, and the ratio of total assets to GDP amounted to 334% in 2007 (Austria: 329%; EU-15: 351%). In the EU-12, the intermediation ratio grew especially strongly, as the general catching-up process continued, but in 2007, the figure for this region still reached 103% only. Regarding lending to different market segments, the growth rates of corporate and household credit (at 14% and nearly 5%, respectively) continued to diverge in 2007. However, the picture is again different for the EU-12, where household lending growth has been especially strong in recent years, amounting to approximately 40% in 2007.

Furthermore, the rise in innovative financial products over the past years has prompted many European banks to move from a "buy and hold" to an **"originate and distribute" business strategy**. Banks following this strategy no longer held credit risk on their own books until maturity – instead, they originated loans, repackaged them into highly rated structured products and sold them to investors.

This allowed them to expand their credit business over the last years and to offer finance also to less creditworthy customers. However, as recent events have shown, incentive problems of the "originate and distribute" model have led to harmful behavior by various market participants and have resulted in a misjudgment and misallocation of risks in the financial system. The lack of transparency of this business model has also made if difficult, for market participants and authorities alike, to determine where the relevant risks and losses were ultimately held. Not all market participants had the level of financial literacy required to understand and manage the associated risks.

2. The recent financial turmoil

These structural changes in the European financial sector combined with a prolonged period of rising profits have set the stage for the **recent financial turmoil**, which (as we all know) was triggered by increasing default rates among holders of U.S. subprime mortgages more than a year ago. The first major transmission channel to EU banks was the provision of liquidity facilities to structured investment vehicles and conduits with exposures to the U.S. subprime market. These facilities were drawn as the vehicles were no longer able to ensure refinancing by issuing asset-backed commercial papers, which led to higher liquidity needs of some credit institutions. Furthermore, the valuation of securitization positions came under pressure, and high losses emerged also in unexpected locations. Many banks were slow to recognize these losses, thus triggering a decline in confidence in the interbank market. This, in turn, led to liquidity shortfalls, but central banks stepped in and temporarily provided additional short- and medium-term funds against collateral. In addition, both private and public sector entities presented detailed proposals of how to restore confidence in the market and solve the problems (for instance, the Financial Stability Forum, the Institute of International Finance, the Counterparty Risk Management Group, and the ECOFIN Council's roadmap).[5)]

In September 2008, the **turbulence intensified again,** following the collapse and near-collapse of several key institutions in the United States and subsequently in Europe.

The viability of some banking practices – investment banking as a whole or the "originate and distribute" business model – has been put into question, and confidence problems have arisen with respect to the financial institutions' ability to repair their balance sheets on their own. The problems were triggered by mounting losses combined with falling asset prices as the deleveraging process intensified and the economic downturn deepened. Liquidity evaporated for many securities that were affected by the turmoil, which posed a challenge for financial institutions, both regarding the valuation of these securities and in terms of additional write-downs. These factors have led to a rapid decline in financial institutions' share prices as well as to higher funding costs and credit protection, among other things. Furthermore, markets have become unable or unwilling to provide capital and funding as worries about counterpartyrisk have intensified,thus leading to additional liquidity strains for financial institutions.

In response to the financial crisis, the authorities in numerous countries have taken rapid **measures** regarding liquidity provisioning, capital injections and/or guarantees for the financial sector as well as increases in the deposit insurance. These measures aim at quickly re-establishing confidence in, and the proper functioning of, the financial market. In the EU, decisions on public intervention were still taken at the national level, but the EU governments agreed on a coordinated response and committed to taking all measures necessary to enhance the soundness and stability of the banking system as well as protect the deposits of individual savers. This includes, among other things, supporting systemically important financial institutions as well as increasing the deposit insurance to EUR 50,000 by December 2008 and potentially to EUR 100,000 at a later stage.

3. EU regulatory and supervisory arrangements

When we wish to analyze what lessons might be learned from the financial turmoil and what might be the consequences for regulatory and supervisory arrangements, it is necessary to first look at the current institutional framework so as to identify any potential gaps and areas for improvement.

The regulatory and supervisory arrangements which have shaped the developments in the EU banking sector in recent years are strongly influenced by the **Lamfalussy architecture**.

This four-level, comitology-based regulatory approach was deemed essential by the EU Financial Services Action Plan (FSAP) in order to achieve the goals laid down in the EU Treaty: to create an open internal market for capital movements and trade in financial services. The Lamfalussy framework was first implemented in the field of securities regulation and was extended to all financial sectors at a later stage. Its basic principles are well known: Decisions on framework directives are taken by the EU Council and the European Parliament (i.e. Level I). EU regulators assist the Commission in adopting the relevant implementing measures at Level II. The three sectoral Level III committees – Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR) and Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) – are composed of national supervisors and are entrusted with the task of fostering supervisory and regulatory convergence within the EU. All central banks, regardless of whether or not they have supervisory responsibilities, participate in the Level III committee for the banking sector, CEBS. At Level IV, the Commission ensures the timely and correct transposition of EU legislation into national law.

The Lamfalussy process has significantly contributed to the development of a more flexible European regulatory system and has paved the way for greater **supervisory cooperation and convergence**. The framework introduced and applied various regulatory principles such as open consultations, impact analyses, early and thoroughinvolvement ofmarket professionals and consumer organizations as well as national regulators in the legislative process. Overall, the decision-making process was deemed to be more efficient than before the Lamfalussy architecture was put in place. However, the process was also criticized as being still too slow. Moreover, the changes in the financial landscape over the past years – such as the creation of large banking groups with major operations in multiple jurisdictions as well as the recent market turbulence – posed new challenges for the existing EU regulatory framework. For these reasons, the European Commission conducted a **review of the Lamfalussy process** at the end of 2007.

In the course of this review, the Commission identified several policy areas for improvement and greater supervisory convergence. One of these areas was the legislative process and enforcement. In order to foster better regulation, for instance, the Commission urged Member States to refrain from "gold-plating", i.e. adding national rules to the ones agreed at European level.

With respect to supervisory cooperation and convergence, the Commissionrecommended strengthening the Level III committees by enhancing their political accountability and reinforcing their legal status, thus increasing their institutional standing. In addition, the cooperation between home and host supervisors was strengthened: colleges of supervisors were created to facilitate cooperation regarding the oversight of large cross-border banking groups.

4. What are the implications of the recent financial turmoil for the future of financial supervision?

As a consequence of the Lamfalussy review and the current financial turmoil, the discussion about the future of financial supervision in Europe has intensified, and efforts to strengthen supervisory arrangements for financial institutions within the EU have gained momentum.

Let me first turn to the future of financial supervision. The current European architecture of banking supervision is based on the responsibility of national supervisors, on regulatory minimum harmonization and on cooperation through home-host arrangements for cross-border banking groups. Furthermore, as discussed, national supervisors cooperate in the Level III committees CEBS, CEIOPS and CESR. Given that **the degree of political and financial integration within the EU is currently increasing but still contained**, **I regard this approach as appropriate**. At the moment, the instruments for preventing and resolving a systemic crisis – in particular the financial resources to shoulder the fall-out of financial turmoil – are still restricted to the national level.

We all welcome the ongoing process of integration – to which I have eluded above – because it will increase efficiency and foster growth. Still, we should bear in mind that higher integration comes at the cost of potential systemic threats gaining importance at the EU level. I am referring to developments like the emergence of banks that are of systemic importance in more than one Member State or the growing number of countries in which foreign banks are systemically important. The current turmoil provides a number of revealing examples in this respect.

How should we address the financial stability implications of financial integration? Three options are discussed among policy makers and market participants:

- a lead supervisor model in which a single national supervisory body would be responsible for the supervision of all parts of a banking group and act as one-stop-shop;
- the evolution of the current European architecture from which a decentralized European System of Banking Supervisors might emerge;
- and the creation of a European Financial Supervisor who would be responsible for the supervision of all banks or at least all cross-border banks in the EU.

In the **lead supervisor approach**, banks operating in the same market would be subject to different supervisory regimes, as the lead supervisor would not only supervise the parent institution and the consolidated group, but also the subsidiaries established in other Member States. I personally firmly believe that this approach is not the right answer, neither in the short term or as intermediate step, nor in the long term. The lead supervisor would hinder the development of an EU-wide supervisory approach and lead to group-specific and fragmented supervisory regimes. Banks would therefore be faced with level playing field problems, since they would conduct business on the same local markets but be subject to different supervisory regimes. Moreover, the lead supervisor approach would not take into account the legitimate interests of local supervisors and governments. The local entities would be supervised by a foreign authority with very limited incentives to provide information, while responsibility for financial market stability would remain with the local authorities. The arrangement would be challenged for its lack of legitimacy, transparency, and accountability. It goes without saying that these are extremely unfavourable preconditions for effective crisis management and resolution. The only advantage of the lead supervisor is that it provides banks with a single point of contact, but this cannot outweigh all the detrimental effects and legal problems it creates. Therefore, from my perspective the lead supervisor approach – or any move in this direction by shifting responsibilities from the local to the consolidating supervisor – is no option at all.

The current European architecture of banking supervision has proved to be quite effective so far. This is why I advocate its **step -wise evolution in parallel with the evolution of European financial and political integration**. In the long term perspective, a decentralised European System of Banking Supervisors could emerge. In such a system, a European Banking Supervisory Authority should act as regulator and take all supervisory decisions on cross-border banking groups.

At the same time, and coordinated by the European Supervisor, the fact-finding in terms of on-site inspections and off-site analyses should remain on national level. This would ensure that supervisors have local market knowledge. Overall, these arrangements would naturally require effective information exchange in both directions, and decisions would be taken based on full information about the whole group. For banks that are predominantly active on national level, the national authorities would keep their current responsibilities. This would not only avoid an overburdening of the European Supervisor, but also be consistent with the principle of subsidiary.

I would therefore suggest the establishing of some kind of "**masterplan**", a roadmap with defined milestones and timelines. Steps that would have to be included are, among others, the achievement of harmonised supervisory requirements or – if this is not sufficiently possible – the agreement on a 28th supervisory regime for the cross-border banking groups. Moreover, adequate administrative rules, winding-up procedures and deposit guarantee arrangements would have to be defined. It is evident that these issues have to be analysed in detail and that carefully designed solutions are required in order to limit interference and incompatibility with national legal frameworks. The structure would have to ensure that the different allocation of supervisory authorities to banks operating in the same market would not lead to a distortion of competition, i.e. regulatory and supervisory convergence are pre-requisites for the potential evolution of a European supervisor. Important issues of legitimacy, transparency, and – most importantly – accountability would have to be solved beforehand. Furthermore, either an EU budget capable of bearing the burden of intervention in large cross-border banking groups or a way to tab national budgets are necessary for a European Supervisor to crystallize.

The evolutionary approach will ensure that potential challenges for financial stability can be addressed at each stage of the process as they emerge. At the same time, it will allow us to assess the need for further harmonization of the supervisory framework at each stage of the integration process. This flexibility is pivotal, because it is impossible to forecast the exact nature of the effects that each step in the financial integration process might have and its financial stability implications. Financial innovation and market developments can diverge across national markets. As best practices emerge, they can be adopted across the EU.From my point of view, thisevolutionary approach is thus clearly preferable, as it avoids severe disadvantages.

Given the current level of regulatory and supervisory convergence, the lack of a sizeable EU budget and the state of political integration a **single, centralized European Financial Supervisor** who would be responsible for the supervision of all banks or at least all cross-border banks in the EU is clearly beyond reach. It would lack legitimacy, transparency, and accountability with respect those who would eventually have to foot the bill for crisis resolution and take the necessary legal steps at the national level, i.e. national tax payers and parliaments, respectively.

The decisive action taken by the EU governments at the beginning of October vividly demonstrates that the current framework of financialsupervision enables theEU to take coordinated and thorough action to address fundamental challenges arising for the financial system. At the same time, the EU's approach reflects that – in the absence of full political and fiscal integration – the potential burden of recapitalizations and targeted guarantees can only rest with national taxpayers, who have taken on substantial risks in all rescue packages. Consequently,they expect transparency, legitimacy and accountability of institutions involved in supervision – after all, these institutions are charged with the task of minimizing the probability with which the risks embedded in the rescue packages materialize.

5. (How)Should we strengthen the existing EU supervisory framework?

Let me now turn to another consequence the financial turmoil has had for financial supervision, namely efforts to strengthen the existing EU supervisory arrangements for financial institutions. In my view, the challenges posed by the current financial turmoil have led to a **number of fruitful steps within the evolution of financial supervision** in Europe:

First, an important step within the evolutionary approach is the establishment of a **financial crisis cell**. This mechanism will bring together representatives of the Presidency-in-office, the President of the Commission, the President of the ECB (together with the other European central banks), the President of the Eurogroup and EU government representatives. Member States faced with a crisis may invoke this mechanism at any time, thus ensuring that information is provided immediately and in confidence to the institutions and all Member States. It will also help ensure smooth coordination of actions taken.

Second, the EU's response to the current turmoil highlights the importance of taking into account potential negative externalities of national supervisory decisions. Therefore, it makes great sense to request national supervisory authorities to consider the **financial stability implications** their decisions may have **for other EU Member States** and to include the tasks of promoting cooperation and working toward convergence in the supervisors' mandates. Although the European dimension in supervisory decisions is an abstract notion that aims at increasing supervisors' awareness of potential negative externalities much rather than an enforceable legal obligation, I expect it to substantially enhance the spirit of cooperation among authorities.

Third, I welcome the recent proposals put forward by the European Commission with respect to **promoting the exchange of information and enhancing cooperation** among the competent authorities: The timely multilateral exchange of information is crucial especially in crisis situations, given the largenumber of authorities involvedin crisis management – ministries of finance, financial supervisory authorities and central banks of all countries involved. Therefore, specifying the **legal framework for transmitting information** from supervisoryagencies to ministries of finance and central banks isan important measure within the evolutionary approach, as isthe improvement of information rights of host country supervisors of systemicallyrelevant branches. The Memorandum of Understanding on cross-border cooperation in the area of financial stability between EU countries' financial supervisory authorities, central banks and finance ministries of June 2008 marks an important milestone in this context.

Fourth, I would like to focus on an area in which important steps in the evolutionary approach are under way – the area of **home -host arrangements** within the EU.

As mentioned before, Austrian banks are among the largest and most successful banks in the Central and Eastern European EU Member States. On the one hand,they aresystemically important in many of these markets. On the other hand, their group headquarters are systemically important for financial stability in Austria as well. Furthermore, one of the largest banks operating in Austria is a subsidiary of a cross-border banking group. I can therefore assure you that I am are very much aware of both sides of the coin of the home-host issue. In this respect, the Austrian authorities fully support all measures to increase cooperation and information-sharing between the supervisory bodies in charge of cross-border banking groups.

Over the past decade, collaboration between the competent authorities within and across EU Members States has improved greatly. In particular the establishment of the Level III committees has contributed substantially to the convergence of supervisory practices and to the exchange of information among European supervisors.

Given the dynamics of cross-border financial integration, it is only natural that the framework of the Level 3 committees has to develop over time so as to reflect the dynamics of the underlying markets, products and institutions.

In a recent ECOFIN meeting, theCouncil reached theconclusion that **specific tasks should be explicitly assigned to the committees of supervisors** (CEBS, CEIOPS and CESAR) by the end of the year, for example, mediation or drafting recommendations and guidelines. The ongoing integration and internationalization of EU financial markets leads to an increasing number of cross-border banking groups. The current allocation of supervisory tasks to home and host supervisors has proved quite effective in recent years. Nevertheless, reinforcing the efficiency and effectiveness of supervision is a welcome further step in the evolution of the European supervisory architecture.

The committees of supervisors are now requested to lay down the principle of **qualified majority decision-making** in their charters, together with a “comply or explain” mechanism. Although the committees shall continue to aim at reaching unanimity in their decisions, I expect this process to support convergence, as it will facilitate peer pressure and encourage supervisors to comply with the committees’ recommendationsas far aspossible. Even though the rule of law in the Member States requires the committees’ decisions to remain legally non-binding,they shouldexplore possibilities for strengthening the national application of their guidelines, standards and recommendations.

I believe the establishment of **colleges of supervisors** will facilitate the tasks of both, the consolidating supervisor and host supervisors. Two core issues in the supervision of cross-border groups are the supervisory review process and reporting requirements. Having served as CEO of a cross-border bank myself, I am very well aware of the burden banks face in dealing with different supervisory practices in both areas. In this respect, I am convinced that a common understanding of these two key aspects of group supervision will contribute to the convergence of supervisory practices and cut red tape for market participants without compromising financial stability.

Finally, CEBS will support the colleges’ work by sharing best practice examples and basic principles for the well-functioning of colleges.

Finally, the convergenceof **reporting requirements** is a fifth step within the evolutionary process. Let me share a few thoughts on this issue. We are all aware that timely and accurate information is pivotal in supervision and crisis management. Against the background of different supervisory approaches, the FINREP (Financial Reporting) and the COREP (Common Reporting) frameworks should be seen as first comprehensive steps to harmonize the reporting requirements on an EU-wide basis. Given the starting point (that is, a wide variety of reporting approaches), the development and implementation of both frameworks represents a distinct improvement in convergence. In this context, I want to stress that COREP has achieved the first-ever use of common prudential reporting of solvency calculations that are comparable on a cross-border basis. The degree of commonality seems to be generally significant in many COREP templates; on the other hand, FINREP has achieved an almost fully harmonized use of core templates, while the remaining FINREP templates (those providing core information details) are usually applied less by most members. Despite all advantages of convergence of reporting requirements, we should also bear in mind that effective supervision requires a reliable and timely set of reporting data. Convergence must lead to a race to the bottom in reporting requirements.

6. Conclusions

Ladies and Gentlemen,

The supervisory and regulatory architecture in the European Union is faced with serious challenges such as the increasing integration and internationalization of the financialsector as well as the risingmarket concentration owing to the emergence of large, systemically relevant credit institutions that are active in multiple jurisdictions. The current financial turmoil puts additional strain on these current arrangements, thus posing challenges but at the same time also creating opportunities for future developments. So far, the step-wise evolution of the European financial architecture in parallel with the evolution of European financial and political integration has proved effective. This approach has two distinct advantages:

Both the potential challenges for financial stability and the requirements for further convergence of supervisory practice are addressed at each stage of the process as they emerge and in the appropriate manner. In the long term perspective, eventually a de-centralised European System of Banking Supervisors might emerge from an evolutionary approach. I do acknowledge that supervisory convergence is stillincomplete, but we have achieveda great deal of progress in recent years and I am sure we are on the right track to cope with the recent challenges in an appropriate and effective manner.

1) The ECB considers the market for a given set of financial instruments or services to be fully integrated when all potential participants in such a market (i) are subject to a single set of rules when deciding to buy of sell those financial instruments or

services, (ii) have equal access to this set of financial instruments or services, and (iii) are treated equally when they operate in the market. See also ECB, Financial Integration in Europe, April 2007.

2) Differences in national economies refer i.a. to credit and interest rate risk, industrial structure and capital market development, while institutional factors refer to taxation, regulation and supervision. Differences in the financial structure may include divergent bank/capital market financing and competitiveness.

3) The EU-12 are Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovenia, and Slovakia.

4) Figures are taken from ECB, EU Banking Structures, October 2008.

5) See also Financial Stability Forum, Report on Enhancing Market and Institutional Resilience, April 2008; Institute of International Finance, Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, July 2008; Counterparty Risk Management Group, Containing Systemic Risk: The Road to Reform, August 2008.