Belgian Financial Forum Conference

The new European financial supervision framework applied to cross-border banks and the possible specific implications for small countries

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“The new European financial supervision framework applied to cross-border banks and the possible specific implications for small countries”

I was asked to talk today about the question of the supervision of cross-border institutions in Europe and its relationship with small economies.

In Europe there are around 5,000 banks (8.000 in the US). Of that number, the great majority are small and medium-sized domestic - frequently regional - institutions. They are confronted by around forty cross-border groups representing almost 70% of the European market. Those groups have seen dramatic asset growth: in excess of 50% between 2001 and 2005.

I shall organise my talk around three topics:

1. Why and how should we ensure a harmonised supervision of European financial institutions?
2. How can we achieve that aim more specifically in the case of the international groups?
3. What impact might the proposed reforms have on the “small” economies?

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I. Why and how should we arrange the harmonised supervision of European financial institutions?

1) *The reasons justifying that aim*

a) <u>Completion of the single market</u>

A single market in goods, services, people and capital was established in Europe fifteen years ago, and we have had a single currency since 1999. Smooth operation of that market’s financial segment presupposes not only that capital can move freely between Union members, but also that European financial institutions can develop efficiently without having to contend with the obstacles of multiple sets of regulations and national controls.

If the supervision of cross-border financial groups is fragmented on a national basis – as is still largely the case today – that is not only incompatible with the smooth operation of the single market but also with the need for international competition. Europe should not deprive its consumers of the economies of scale inherent in the existence of groups with access to international production platforms.

b) <u>This harmonisation of supervision is also vital to make the institutions more secure</u>

Banking is, by nature, a risky occupation: that risk emanates essentially from the transformation of short-term resources (particularly sight deposits) into medium- and long-term loans. To mitigate that risk, it is important for supervision and financial regulation to ensure that savers and depositors are equally well protected, regardless of whether the institutions which they patronise operate nationally or internationally.

To achieve that, it is essential for the supervision of transnational groups - by definition, more complicated than the supervision of "domestic" institutions - to be organised in a clear and consistent manner. I shall come back to this basic point later on.

2) How to achieve that aim?

After talking about the options which are theoretically possible, I shall describe the solutions advocated in the report produced at the end of February 2009 by the Committee of which I was chairman.

a) <u>Theoretically possible options</u>

These can be structured around the dilemma as expressed by some European Union countries, namely:

"more Europe,
or less Europe".

If we want "more Europe", we need to unify the rules applicable to financial institutions in the EU and achieve harmonised supervision of private institutions (according to the most demanding standards).

If these two conditions were perfectly fulfilled, there would be no reason – according to those who state the dilemma – why European transnational groups should not develop to form a genuine single market in financial services.

But, as the argument goes, we are a long way from fulfilling these conditions. In the interests of savers and taxpayers, we are therefore forced to operate an essentially national system of supervision. According to this argument, every country must be able to exercise supervision on a national basis over foreign institutions (subsidiaries and even branches) established in its territory.

Excessive external expansion on the part of certain weak institutions lacking adequate supervision (such as the Irish and Icelandic banks, in particular) have added fuel to the arguments of those currently wanting "less Europe".

In fact, the authorities in Reykjavik ("home supervisor") proved incapable of protecting the deposits of customers from European countries who had been tempted by the high returns offered by Icelandic bank branches based in Britain, the Netherlands and Germany, for example. Those host countries therefore had to draw on their own resources to safeguard deposits placed with bank branches over which they had practically no control.[1]

I believe it is possible - and vital – not to get bogged down in this over-simplistic dilemma.

b) <u>The pragmatic solutions proposed</u>

These consist in setting up a "European system of financial supervision". The three essential elements are as follows:

- <u>Try to prevent crises by surveillance of systemic risks</u>.

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[1] The President of Iceland has just decided to hold a referendum on the agreement concluded by the Icelandic Government with the United Kingdom and the Netherlands whereby Iceland will repay 3.9 billion euro (1/3 of Iceland's GDP) in respect of deposits placed with Icelandic bank branches based in the two countries in question (La Presse – 7 January 2010).

The idea is simple. Even if national micro-supervision of private institutions is correctly applied, it does not automatically result, on aggregate, in the stability of the financial system as a whole.
At macroeconomic and financial level, there are in fact risks which are beyond the powers of the micro-supervisors, such as tendencies towards the excessive expansion of credit, the creation of asset bubbles, etc.

We therefore felt it important to entrust the continuous monitoring of such risks to a "Systemic Risk Board" – essentially composed of the governors of the Central Banks of the European Union and the supervisors, under the aegis of the ECB.

But that monitoring must not remain theoretical, or lead to reports on which no action is taken, as has happened too often in the past. Where necessary, the Systemic Risk Board will have to formulate specific recommendations addressed to the competent authorities (states, central banks, regulators or supervisors). If no action is taken on the recommendations, the matter will be referred to the European Council.

If we had had an instrument of this type, events such as the Icelandic crisis or the excessive household debt levels in foreign currencies, seen in some Central European countries, could have been avoided or at least kept within bounds.

- <u>Establish common financial rules for Europe</u>

One of the paradoxes of Europe is that, despite harmonised legislation (directives), we have ended up with regulations which often vary widely from one country to another. This is due to the use of "national exceptions" which have proliferated and resulted in very diverse ways of transposing Community legislation into national law, encouraging regulatory arbitrage. Our report advocates abandoning national exceptions in the future (unless their effect is to increase the stringency of Community regulations) and correcting the most harmful divergences in current texts.

- <u>Step up the coordination of the national supervisory authorities and create a "European supervision system"</u>.

We have not gone so far as proposing the creation of a single micro-supervisor at federal level. Some people would have liked that. We felt that this idea was ahead of its time, that it had its drawbacks, and would have lacked the necessary political support.

We considered it more realistic – and more efficient - to leave the national authorities to continue exercising daily supervision over their financial institutions.

But on the other hand, it is vital to ensure that European micro-supervision is genuinely consistent by converting the existing consultative committees (Lamfalussy committees) into three "Authorities" with decision-making powers on specific subjects. Here are some examples:

- Fixing the (often divergent) interpretation of Community texts. If the authority decides by a qualified majority, the interpretation adopted becomes binding.
- Establishing technical standards downstream of the texts (directives or regulations).
- Binding mediation in the case of differences of opinion between two supervisors.

If these "authorities" seize the opportunity which they are given, we should see the gradual development of a common culture of supervision and risk analysis.

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II. How can we ensure that these principles are applied in the specific case of the supervision of cross-border groups?

This is the problem of relations between the "home" and "host" supervisors.

We have centred our recommendations in this area around two fundamental ideas:

- Generalised introduction of colleges of supervisors.
- The rules to be respected.

1) Generalised introduction of colleges of supervisors

This idea is crucial. We cannot achieve proper governance of the supervision of transnational groups unless the supervisors responsible for monitoring the subsidiaries (and even branches) of those groups are fully involved in the supervision exercised by the "home supervisor" over the parent company.

I am glad that the establishment of these colleges – some of which were already operating before we presented our report – is proceeding apace.

Europe currently has around 36 colleges.[2] And they are beginning to operate internationally in the case of groups whose activities extend beyond the boundaries of the European Union.

2) *The rules of the game*

Rather than putting forward radical solutions (such as: “the home supervisor is the lead supervisor who always has the last word in the college”), the report proposed solutions which are more nuanced but, in my view, more realistic.

We know all too well that the radical solution of the “lead supervisor” led to a political stalemate during the 2007-2008 discussions on the Solvency II directive.

We therefore wanted to take account of the reticence of some Member States – and particularly the “new members” – in regard to this fundamental question of the practical organisation of group supervision.

The central idea is that the college of supervisors is the keystone of the arrangement. It is the place for the exchange of ideas and opinions, for meetings, mutual explanations and solutions to everyday practical problems.

But the efficient operation of a college is not sufficient to ensure the successful supervision of cross-border groups. First, because the various colleges - inevitably influenced by the “home” supervisor – could move in different directions depending on the case, and that would exacerbate the inconsistencies and divergences in the present system. And next, because the colleges - deprived of ultimate authority (we have seen that it was politically unacceptable to give the “home supervisor” power of decision) - are liable to become bogged down and incapable of taking action in the event of differences of opinion between supervisors.

To avert these two dangers (inconsistencies between colleges, failure to act in the event of disagreement within a college), the report proposes “to take the top way out”.

[2] All the other colleges are to be set up in 2010, as the C.R.D. has to be implemented with effect from 31 December 2010.

a) *The risk of inconsistency in supervisory practices between colleges*

That risk will be small, by definition, and will be eliminated, if possible, by the creation of supervisory authorities. One of the tasks of those authorities will in fact be to ensure consistency in the supervisory practices adopted by the colleges. The fact that the "authorities" will in future attend the college meetings will reinforce their role as coordinators.

b) *The risk of becoming bogged down*

In the event of a difference of opinion between two or more supervisors in a college over how to deal with a subsidiary or branch of a particular group, that disagreement must be referred to the "competent authority" for mediation. That authority will resolve the conflict by a qualified majority. In order to ensure that such mediation was binding, the Commission had made provision for exercising a right of direct enforcement over the institution in question. That direct right was removed from the text agreed by the Council of Ministers at the beginning of December 2009. According to the compromise text, the "authority" has to ask the national authority concerned (hostile to the outcome of the mediation) to implement the decision. If that national authority refuses to comply, then the Commission will have to take action against the uncooperative country via the normal legal channels (Court of Justice). Since that is a lengthy procedure, I feel it would be desirable to revert to the Commission's original text and restore the direct right of enforcement in relation to the financial institution concerned, otherwise the credibility of the system of central "authorities" could be seriously impaired.

That said, the current text which is to be submitted to Parliament already represents some progress.

However, a subject which is probably just as important and, from one point of view, more difficult, is that the system of colleges and authorities will not work properly unless the participants have confidence in it. The supervisors are not in the colleges in order to defend national positions or interests. They are there to improve the supervision, security and efficiency of complex groups. The exchange of information - too often constrained at present by the supervisors' fear of revealing confidential data – needs to be free-flowing and transparent. Hence the importance of protecting confidentiality, but not at the price of withholding information. The fact that the "authorities" take part in the colleges (and an ECB representative may be invited to attend) should help to promote this culture of confidence. I am convinced that the exchange of information -

well ahead of any problems - could avoid many of the difficulties encountered "when it is too late".

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III. The question of the "small economies"

1. *We have seen large international financial institutions developing in a number of "small countries".*

That applies to Switzerland and Benelux, in particular, as shown by the attached chart.[3] This has mainly concerned market activities, to a much greater extent than commercial banking, and particularly retail banking. That characteristic is due to the development of the financial markets, their interconnections and the ease with which these institutions can establish trading positions, despite their small hinterland. For example, the regulatory system has clearly encouraged all institutions – whether they are from small countries or large ones – to create off-balance-sheet vehicles and abuse securitisation. For a given amount of regulatory own funds, these processes permitted a much higher capital "turnover", thus expanding the creation of credit in a dangerously procyclical way. That gave the institutions in question the illusion that securitised or off-balance-sheet products had been dispersed and would never come back to haunt them. We have seen how the crisis destroyed those illusions.

Initially, therefore, the problem is not so much connected with the size of the country where the parent company is based. It is connected primarily with the lack of risk assessment and management on the part of both the supervisors and the financial institutions in question.

This has concerned almost all countries (although certain groups – particularly on the European continent – were much more prudent in their behaviour). When the credit bubble began to collapse in the summer of 2007 with the subprime crisis, all the refinancing markets dried up.

The cost to the European Union of the total aid given to financial institutions in all forms, whether disbursed or not (loans, liquidity, guarantees, asset purchases,

[3] This shows that the banking sector's assets come to 800% of GDP in Switzerland, over 600% in Belgium, and over 500% in the Netherlands, whereas the proportions range between 100 and 300% for the large industrialised countries.

capital participations, etc.), is in the region of 3,700 billion euro, or around 25 % of Europe's GDP (the figure for the United States, which has a comparable GDP, is around $12,000 billion).

Clearly, the "small countries" – owing to the expansion of their groups and the size of those groups in terms of their GDP – suffered a much harder blow to their budget, relatively speaking, than the larger countries.

Thus, UBS (whose assets represented 5 times the national GDP), Crédit Suisse (3 times), and Fortis (2.5 times) were particularly notable examples (although Credit Suisse did not receive any public aid). In relative terms – in relation to the contributory capacity of the countries in question measured according to their GDP – their size and market share are off the scale compared to those of institutions such as City Bank, although the exposures and aid packages of those institutions were also massive[4].

Alongside the concept of "too big to fail" we therefore also have, to some extent, the concept of "too big to be rescued". For example, we need only remember that the total amount of the government guarantees which the Icelandic banks enjoyed, in principle, came to over 250% of national GDP.

These situations led to either defaults on deposit guarantees (Iceland) or "ring fencing" between countries (to try to limit the repercussions of the bail-out and put a geographical restriction on liquid resources), or to massive public aid often accompanied by mergers.

2. *How to improve the protection of the system?*

The first lesson to be drawn from these events is that the essence of the solution lies in the quality of the supervision and risk management. There are those, such as the Swiss National Bank, who also advocate a "leverage ratio" intended primarily to reduce the size of their banks' balance sheets and maintain control over them. Although I can see the benefits of such a measure for a country like Switzerland, I have my doubts about the general justification for a standard leverage ratio. I think it would be more appropriate to vary the capital requirements

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[4] The table in Annex II shows the disparity between European countries in the percentage of GDP represented by rescue payments to the banks (EU average : 1.7%, Ireland (19.16 %), Luxembourg (7.64 %), Belgium (5.17 %), France (0.85 %), Spain (0.09 %), etc. Source : European Commission – Working Document 07.12.2009

according to the nature of the risks which the institutions incur (particularly in regard to proprietary trading) and to introduce appropriate liquidity constraints.

Earlier detection of systemic risks – as advocated in Europe - could alert the supervisory authorities while there is still time, and avoid the procyclical excesses which have too often been a feature of banking activity in recent years.

Also, the existence of colleges which operate effectively and engender a common culture and a genuine exchange of information would be a step towards better crisis prevention and the more orderly resolution of crises potentially affecting a cross-border group.

Finally, there is another recommendation which could be decisive, particularly for solving the problems of complex institutions belonging to small countries. The idea is to prepare the groups for the measures to be taken in the event of difficulties, well before the problems arise. The United States have made great progress on this subject of "Resolution". It is not a question of abandoning liquidation, but of ensuring that the "unwinding" takes place in an orderly fashion. Obliging the groups to make advance preparations for their dismantling or restructuring ("living wills"). Getting governments to agree – at European and global level – on the procedure for granting public aid (in the form of an objective approach to burden sharing). Here, too, the European "authorities" could play a useful role as "facilitators".

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These are a few of the points to consider on the subject that you have asked me to talk about.

But let us never forget that, whatever the value of the regulatory proposals which I have mentioned, the key to success lies primarily in the quality of the people, the managers. It is their practical experience, the years spent in weighing up the risks, and understanding and managing complex operations, the way in which they distance themselves from herd behaviour, their ability to question "the latest good idea", their suspicion of short-term models, their ability to reject what they do not understand, their long-term view, and their prudence which – at the end of the day – will make the difference and reduce the "moral hazard" which has reached unacceptable proportions during this crisis.

Jacques de Larosière

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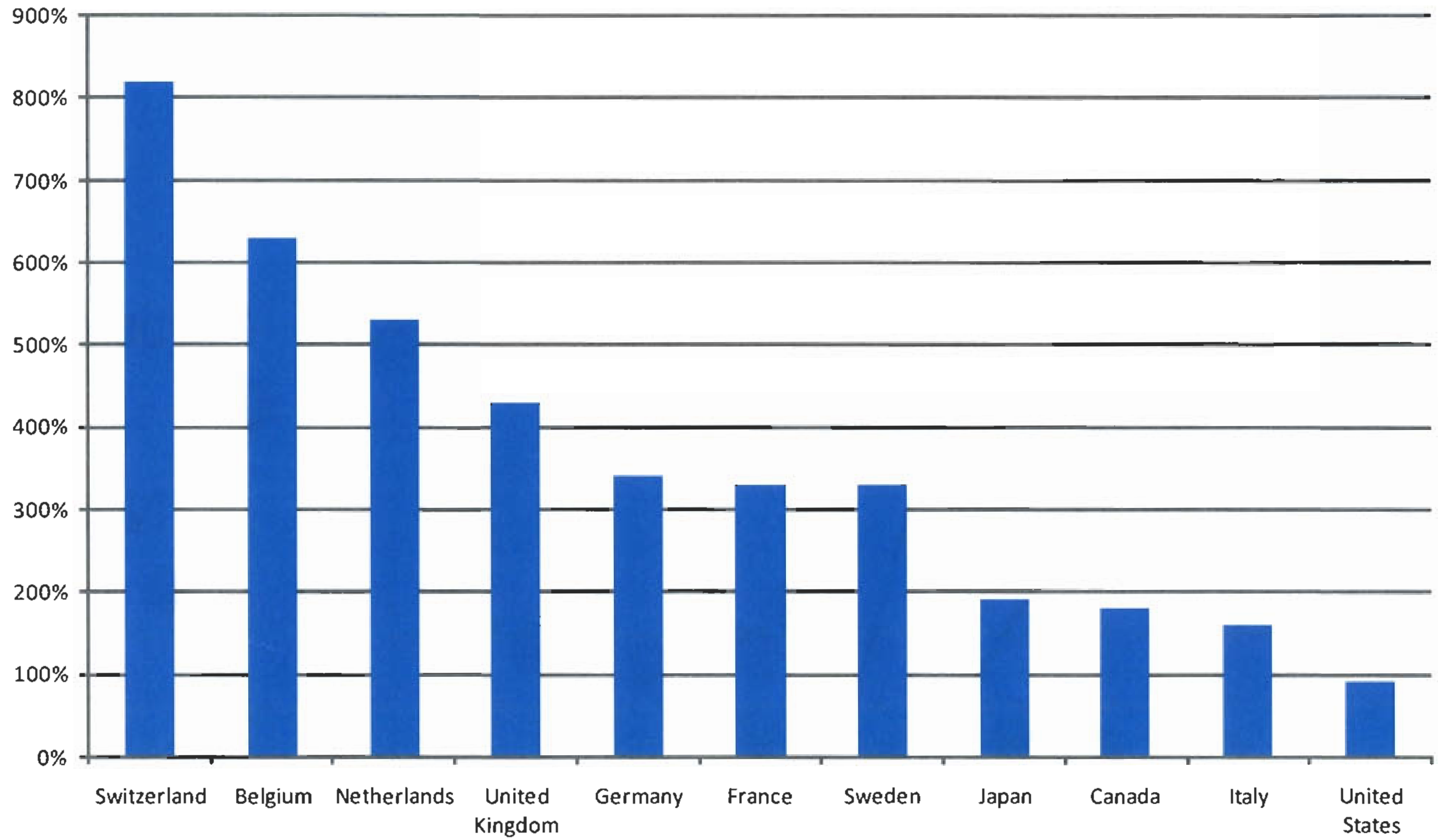
Banking Sector Assets in Comparison with GDP



Sources: SNB, *Annual Reports (2007 and 2008)*, IMF

Annexe II

Figure 20: State aid related to crisis measures (2008; figures in billion €) – Source: DG Competition

	Total volume approved in 2008	*Total volume approved 1.1. - 31.03.2009*	Total volume approved from 2008 to 31.3.2009	*Total volume approved 1.4. - 11.11.2009*	Total volume approved from 2008 to 11.11.2009	Grants	Equity participation reported for 2008		Soft loans reported for 2008		Guarantees reported for 2008		Total crisis aid reported for 2008		Total crisis aid granted as % of GDP	Share of banking sector as % of total economy
							Nominal value	Estimated aid element*	Nominal value	Estimated aid element*	Nominal value	Estimated aid element*	Nominal value	Estimated aid element*	%	%
Belgium	255.15	*7.80*	262.95	*25.36*	288.31		16.40	11.70			30.40	6.08	46.80	17.78	5.17	5.4
Denmark	585.44	*13.50*	598.94	*0.82*	599.75		0.50	0.50	2.35	2.35	0.00	0.00	2.85	2.85	1.22	5.4
Germany	545.23	*20.00*	565.23	*23.90*	589.13	8.86	11.20	11.20	23.78	3.17	137.10	27.90	180.94	51.14	2.05	3.6
Ireland	376.00	*5.00*	381.00	*7.50*	388.50						355.76	35.58	355.76	35.58	19.16	10.9
Greece	28.00		28.00		28.00											4.0
Spain	250.00		250.00		250.00		-	-			99.13	0.93	99.13	0.93	0.09	5.1
France	341.25	*4.70*	345.95		345.95		11.50	11.50			31.40	4.98	42.90	16.48	0.85	4.7
Italy	20.00		20.00		20.00											4.8
Cyprus				*3.00*	3.00											7.8
Latvia	7.44		7.44		7.44				0.96	0.96			0.96	0.96	4.17	6.2
Luxembourg	7.00		7.00	*0.26*	7.26		2.50	2.50			1.50	0.30	4.00	2.80	7.64	29.1
Hungary		*5.99*	5.99	*0.04*	6.03											4.0
Netherlands	217.75	*22.79*	240.54		240.54		10.75	10.75	3.00	3.00	3.34	0.33	17.09	14.08	2.37	5.6
Austria	90.00		90.00	*0.10*	90.10											5.6
Poland				*10.00*	10.00											5.1
Portugal	20.00	*0.45*	20.45	*4.00*	24.45						4.30	0.43	4.30	0.43	0.26	8.2
Slovenia	12.00		12.00		12.00											4.3
Finland	50.00		50.00	*4.00*	54.00						0.12	0.00	0.12	0.00		2.9
Sweden	150.52	*4.80*	155.32		155.32		0.25	0.25	0.00	0.00	1.14	0.11	1.39	0.36	0.11	3.6
United Kingdom	405.15	*11.25*	416.40	*95.77*	512.17	5.02	46.47	46.47	2.86	0.43	146.93	16.83	201.28	68.75	3.79	7.6
Total EU-27	**3360.92**	***96.28***	**3457.20**	***174.74***	**3631.94**	**13.89**	**99.57**	**94.87**	**32.95**	**9.92**	**811.12**	**93.48**	**957.52**	**212.15**	**1.70**	-