Lucas Papademos: Banking supervision and financial stability in Europe

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at a conference organised by the European Banking Federation, "Supervision of international banks: Is a bank crisis still possible in Europe?", Brussels, 28 October 2005.

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Ladies and gentlemen,

Thank you for inviting me to this conference. I am very pleased to participate in this panel discussion. Our subject today – the future of banking supervision in Europe – is topical and important. It is and will remain a key area of financial services policy in the EU over the coming years. Effective and efficient banking supervision is essential both to promote financial integration and to safeguard financial stability. From a financial integration perspective, the main priority is to remove any supervisory obstacles to cross-border finance, notably via enhanced supervisory cooperation and convergence. Other panellists will certainly address these issues in some detail. In my speech, I will focus on potential challenges for EU banking supervision from a financial stability perspective and assess the existing institutional arrangements in this regard.

I. Challenges to banking supervision and financial stability

Let me start by pointing to some developments in the banking sector which may pose challenges to current financial stability arrangements. As we are all aware, the financial integration process – in the EU as well as on a global level – has involved a substantial increase in cross-border banking. Four developments can be mentioned in this respect. First, banks have considerably expanded their cross-border banking activities in Europe, especially in the wholesale and capital markets. For example, in 2005 cross-border interbank loans account for 30% of total interbank loans and the share of cross-border bank holdings of non-bank securities in the total holdings of such securities by banks is more than 45%; in 1997, however, both figures stood at around 20%. Second, a number of large and complex institutions spanning several jurisdictions have emerged. Some of them are akin to pan-European players. The 14 largest of these cross-border banking groups already account for almost one-third of total banking assets in the EU. Third, large foreign establishments with a significant market share in host countries have become more prevalent, especially, but not exclusively, in the new Member States. Finally, cross-border banking groups are increasingly centralising key business functions such as credit risk and liquidity management, often cutting across separate legal entities in different countries.

The growing prominence of cross-border banking has important financial stability implications. On the one hand, cross-border banking broadens and deepens banking markets, increases liquidity and risk sharing and thus strengthens the overall resilience of the European financial system. On the other hand, national financial systems may be increasingly exposed to common risks, and financial disturbances may be transmitted more easily across borders. Against this background, it is essential to ensure that the EU framework for financial stability is fully prepared to respond to the greater possibility that risks may be cross-border in nature or in origin. This calls for (i) enhanced interplay between home and host authorities, especially with regard to significant foreign entities in host countries, and (ii) the development of effective arrangements for dealing with large and complex EU banking groups.

II. Policy initiatives

What has been done so far to strengthen the EU financial stability framework in order to achieve these objectives? Such a framework comprises arrangements for banking supervision, financial stability monitoring, crisis management and deposit insurance. In the area of banking supervision, two important policy initiatives have recently been taken to enhance home-host cooperation between supervisors and to strengthen cross-border arrangements for the supervision of large and complex banking groups. The first policy measure is the improved legal framework for supervisory cooperation regarding banking groups with foreign subsidiaries, introduced by the recently adopted Capital Requirements Directive (CRD). In particular, the CRD entrusts the consolidating supervisor with coordination responsibilities. It also strengthens and clarifies the requirements for information sharing and cooperation between all authorities responsible for the supervision of group entities. This improved framework should promote and facilitate effective supervisory cooperation, especially for large groups that are active in several countries. The second important policy measure is the extension of the Lamfalussy framework to include the banking sector and the related activities of the Committee of European Banking Supervisors (CEBS) to promote supervisory cooperation. The forthcoming CEBS guidelines for supervisory cooperation will provide concrete guidance for the effective and consistent implementation of the revised legal framework for cross-border banking groups. This will also increase the effectiveness of the arrangements for supervisory cooperation with regard to cross-border banks that have a significant number of foreign branches in host countries.

I would also like to remind you briefly that important initiatives have been taken to enhance the other public policies safeguarding financial stability. For example, in the area of financial stability monitoring, the Economic and Financial Committee's recently established Financial Stability Table has played an important role in forming a comprehensive assessment of risks to financial stability in the EU. This work has been strongly supported by the Eurosystem, notably via the ESCB Banking Supervision Committee's annual report on EU banking sector stability and the biannual ECB Financial Stability Review of the euro area financial system. With regard to crisis management, the adoption of the Memoranda of Understanding on cooperation between central banks, banking supervisors and, more recently, ministries of finance, has been a major accomplishment. Work to carry out simulation exercises to test these arrangements is already underway.

III. Alternative approaches

While the progress achieved is widely acknowledged, some market participants have nevertheless called for a more integrated institutional approach, particularly in the area of banking supervision. Specifically, the introduction of a "lead supervisor" for cross-border banking groups has been proposed. This lead supervisor would not only be responsible for the prudential supervision of all group entities during normal times, but would also coordinate and take the final decision on possible emergency and crisis management measures concerning the group. While the panel discussion this afternoon will offer us the opportunity to debate the possibility of a more integrated supervisory framework in detail, I would like to share with you at this stage some thoughts on this matter.

The development of European financial markets is manifestly a highly dynamic process. The supervision and management of this process requires close monitoring and careful analysis of the current trends. It also requires all responsible authorities to assess, on an ongoing basis, whether the existing institutional arrangements remain appropriate and whether they are likely to cope well with future challenges. Keeping an open mind certainly complements our attitude of considering with caution some of the ideas that call for fundamental institutional changes. Several reasons underlie our position.

First, we consider that the arrangements for supervisory cooperation have been considerably enhanced by the strengthened legal framework for supervisory cooperation and the introduction of the Lamfalussy approach. If fully exploited by all stakeholders, the new arrangements, by promoting supervisory convergence and cooperation, should enable us to effectively address the financial stability challenges lying ahead. The present institutional set-up should therefore be given adequate time to show its effectiveness before alternatives are considered.

Second, any fundamental revisions of the existing supervisory arrangements which challenged the basic principle of national responsibility and accountability would have a number of political, legal and practical implications. Moreover, such changes would affect not only banking supervision, but also other public policies safeguarding financial stability, notably crisis management and deposit insurance. In order to deal with these complex matters effectively, it would be necessary to analyse all these aspects very carefully so as to ensure the consistency, credibility, legal certainty and political legitimacy of the EU framework for financial stability. It is vital that the overall effectiveness and efficiency of the EU institutional arrangements are not endangered and that no concerns arise from a financial stability perspective. Therefore, the ECB favours an evolutionary, rather than a revolutionary, approach to the further development of the EU framework for banking supervision. Nevertheless, if the existing arrangements prove in practice to be insufficiently effective in addressing the challenges associated with the changing financial landscape, consideration should be given to new ideas that would help us to develop the EU supervisory framework further.