Panagiotis Thomopoulos: Banking regulation in Europe - a brief overview of current developments

Speech by Mr Panagiotis Thomopoulos, Deputy Governor of the Bank of Greece, at an event organised by the European Bank Training Network and the Hellenic Bank Association, Athens, 4 May 2006.

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Good evening, Ladies and Gentlemen.

Allow me to begin by welcoming you to Athens and wishing you a pleasant stay. It is a great pleasure and honour for me to address such a distinguished audience. I would also like to seize this opportunity to thank the European Bank Training Network and the Hellenic Bank Association for organising this event and all of you for your participation.

My objective here today is to provide you with a brief overview of the current developments in banking regulation that are taking shape in the European “arena”, and to outline the main challenges that European regulators and supervisors face, as the degree of integration in the European financial market increases.

Before presenting you with some of my thoughts on this subject - a subject which, I am sure, all of you know well - I should like to say a few words about Greece, where I have a comparative advantage. Disciplined by the requirements of euro area candidacy and membership, Greece succeeded in lowering its inflation rate from over 16% in the fifteen years until almost the mid-1990s to just above 3% from 2000 onwards. At the same time, GDP growth rose from less than 1% in the first period to almost 4% over the last ten years. The Greek economic scene has also been transformed thanks to the advantages derived from euro area membership, including the stable macroeconomic environment and low interest rates. The Olympic Games hosted in Athens in 2004 contributed, in turn, to creating a favourable environment for growth. However, liberalisation and privatisations, as well as a reinvigorated private entrepreneurial spirit, have been the principal growth-driving forces.

This spirit has manifested itself in Greece's re-orientation from an inward- to an outward-looking economy. We now see ourselves as a dynamic part of South-East Europe, where large Greek communities, numbering hundreds of thousands, after taking root in the distant past, continued over the centuries to play an important role in the economic and social life of their respective countries. The story of these communities goes back a long way, beginning in ancient Greece, followed by 5 centuries under the Roman Empire, then continuing for 1,000 years during Byzantium. Then came nearly 600 years of Ottoman rule and, more recently, the communist take-over of these countries, which resulted in an expulsion of all non-communist Greeks. After an interlude of some 50 years, the historic forces are back at work. More than 5,000 Greek companies now operate in the neighbouring Balkan countries and are among the main foreign investors in Bulgaria, Fyrom, Romania, Albania and, more recently, Serbia. This development has resulted in a delocalisation of Greek industry to our neighbouring countries and a steady inflow of migrant workers to Greece.

The Greek banking sector has also undergone a radical transformation, evolving from the highly regulated sector it was 15 years ago, when the Bank of Greece set over 150 different levels of interest rates to become a free, competitive and dynamic sector and a key pillar in Greece’s successful economic performance. Despite their relatively small size by European standards, the Greek banks ' high profitability has enabled them to build sound foundations. Just like other sectors, the Greek banking sector has also expanded to South-East Europe. This offers Greek banks the opportunity to benefit from the growth potential of a rapidly developing region with low levels of financial intermediation, to increase their size and efficiency, and to continue to flourish in the very competitive international financial environment. The market penetration of Greek banks, based on their total assets in the neighbouring countries, ranges from 11% to over 30%. Moreover, the foreign claims of Greek commercial banks on the Balkan region countries have reached almost €11 billion, which represents 25% of Greek banks’ total foreign claims and 58% of their own funds.

Unfortunately, the state of the Greek economy is far from rosy and many challenges still lie ahead. After euro area entry, fiscal discipline was relaxed and during the last five years the fiscal deficit has, in fact, worsened. Only this year has it been budgeted to fall below 3% of GDP, while continuous efforts will have to be maintained to reach a balanced position, as required by the EU.

Moreover, the euphoria after euro area entry prompted a " money illusion " with labour unions demanding and obtaining high nominal wage increases, regardless of the impact on real incomes and unemployment, as a result of the the loss of external competitiveness. This makes it even more urgent and imperative to raise productivity growth further and develop high value- added activities. We, therefore, need to intensify our structural adjustment efforts in the labour and product markets, promote innovation and technology, and ease bureaucratic restrictions, as recommended in the Lisbon agenda. My personal opinion is that the morass of bureaucracy is the main impediment to a faster rate of growth. The Greek banking sector thus faces a double challenge: it has to apply all of the new regulations, control mechanisms and risk-based methods (Basel II), while expanding rapidly both in Greece and abroad, and, at the same time, from a risk management and internal control point of view, it has to rapidly integrate its subsidiaries and branches in South-East Europe, where the environment still differs from that of the average euro area country. Expansion toward potentially much larger markets - Turkey, Poland and Egypt today and Ukraine tomorrow - calls for even better internal risk exposure-monitoring systems. This is a parameter which the new capital adequacy framework, in combination with the recently established regulatory framework on internal control, deals with.

The Bank of Greece, as the supervisory authority, has indeed been adapting its regulatory and supervision apparatus to deal with the new challenges, and has encouraged the banking sector to maintain a high Capital Adequacy Ratio (13% at the end of last year). This provides a more than adequate buffer against the fact that uncovered non-performing loans are still slightly higher in Greece than on average in the euro area and the fact that Greek banks are still benefiting from a favourable cyclical phase and, therefore, have not yet experienced the adverse effects of a slowdown. In parallel, given the specificities of Greece ' s banking system and economy, the Bank of Greece has imposed stricter measures on some banks (e.g. a CAR much higher than 8%). Likewise, given the rapid growth of lending to households (30% on average since 2001), the Bank of Greece has instructed banks that debt-servicing burdens on households should not exceed 30-40% of disposable household income. While adhering to the risk-based approach, which gives individual banks more freedom to estimate their possible losses and manage their own risks, the Bank of Greece considers that the supervisory authorities should always be alert (not to say, vigilant) and, when necessary, not only adjust the capital requirements of individual banks, but also periodically test the internal control mechanisms and risk management systems, in the context of Pillar III. Only as a last resort should other more direct measures be applied.

Current developments

Now, getting back to the subject of today ' s conference: During most of the 1990s, efforts in the financial services sector were focused on achieving a smooth changeover to the single European currency. However, once the euro was successfully introduced, attention shifted to improving the functioning of the single European financial market. The late 1990s saw the launching of an ambitious plan - the Financial Services Action Plan - , which contained a series of legislative and other measures that would allow the European financial services sector to gradually realise its full potential.

Since then, major changes have taken and are still taking place in the financial regulation landscape. The most outstanding of them, in the banking sector, is the forthcoming new capital requirements framework, which is one of the final measures of the EU Financial Services Action Plan.

The new capital requirements framework

The new Directive - or CRD as it is called - will make the existing banking supervision framework more risk-sensitive and will promote enhanced risk management among financial institutions. This should improve the effectiveness of the framework in ensuring financial stability, maintaining confidence in financial institutions and supporting the macroeconomic environment in general. Improved risk-sensitivity in capital requirements should facilitate a more effective allocation of capital, thus contributing to boosting the competitiveness of the EU economy. There has, however, been some discordance of opinion about certain aspects of the CRD, which has fortunately been largely resolved.

The new Directive is, in fact, a new supervisory framework of a rather revolutionary nature, adapted to the globalised world we live in. Apart from introducing new approaches for the calculation of capital requirements, the CRD provides for the establishment of intensive cooperation and information exchange mechanisms among supervisors, the option of delegating tasks among supervisors, information exchange requirements among banking supervisors, central banks and finance ministries in emergency situations, and - a completely new element - disclosure requirements both for banks and for supervisors.

Of the above-mentioned elements, one issue that has sparked much debate and, to some extent, controversy, is the allocation of supervisory tasks or responsibilities between the home and the host supervisor, i.e.:

(i) the authority that supervises the parent bank (i.e. the consolidating supervisor) and the authority that supervises a "significant" subsidiary bank or

(ii) the supervisor of the bank located in the country of origin and the supervisor located in the country where a "systemically relevant" branch is established.

The main concern in this debate is finding the right balance, so as to enhance the efficiency of the supervisory arrangements, while ensuring their effectiveness and respecting the existing accountability arrangements at the national level.

The Bank of Greece has a strong interest in the outcome of this debate, in which it actively participates, in the hope that an optimum balance will be reached. Needless to say, this interest also reflects the fact that the Bank of Greece is both the host supervisor for incoming EU banks and the home supervisor for outgoing Greek banks, which are expanding mostly to the neighbouring Balkan countries, some of which are preparing to implement the EU framework. In performing its roles, as mentioned above, the Bank of Greece consistently follows policies that encourage the European integration process and refrains from creating unnecessary administrative burdens or erecting other obstacles, without, of course, putting the effectiveness of its supervisory tasks at risk.

Other regulatory initiatives

- In parallel with the preparation for the new supervisory framework ' s implementation, discussions are under way regarding the revision of the Directive on Deposit Guarantee Schemes and the Electronic Money Directive.
- Another major issue that has sparked considerable controversy concerns the so-called supervisory approval process. The debate was initially triggered by certain market participants, who fear it to be an obstacle to cross-border mergers and acquisitions. The Bank of Greece and the central banks of many other countries have repeatedly stated that isolated cases, in which a misuse of supervisory powers may have occurred, should not be generalised. In Greece, as it is the case in the EU as a whole, the supervisory authorities base their decisions regarding the merger or acquisition by a foreign institution of a domestic bank strictly on supervisory criteria.

The new decision-making structure for financial services

Apart from the introduction of the new capital adequacy framework, another radical change that has been introduced involves the decision-making process at the EU level for the financial sector, also known as the Lamfalussy process. A new financial services committee architecture has been established.

The Lamfalussy approach, which was originally elaborated for the securities sector, now extends to the banking and insurance sector, as well. Given the time constraint, an extensive presentation of the Lamfalussy framework would probably be inappropriate. However, there is reason to underline some of its main objectives, which are:

- to develop regulation that can adapt quickly to new market developments and practices, support integration and enhance EU competitiveness, and
- to strengthen cross-border and cross-sector cooperation among supervisory authorities and the convergence of day-to-day supervisory practices and implementation.

It is worth mentioning that the new decision-making structure has not yet reached its full potential. On the one hand, there is a some concern about the potential proliferation of work among the various committees and working groups and the consequent risk of confusion and wasted resources. On the other hand, the process has started to yield significant benefits, especially in the field of supervisory convergence, which should overcompensate for few negative aspects.

The Committee of European Banking Supervisors (CEBS)

The CEBS, as part of the Lamfalussy framework, is the institutional committee that brings together all the banking supervisors of the EU countries and the central banks, including the ECB, as observers. The CEBS has three main tasks:

- to provide advice to the Commission;
- to ensure the consistent implementation of Community legislation in the banking sector and the convergence of supervisory practices; and
- to promote supervisory cooperation and exchanges of information.

The CEBS has an advisory role within the EU legislative procedure. The CEBS's other focus is to promote a consistent approach to banking supervision through increased convergence of standards and practices and enhanced cooperation and information sharing. The ultimate goal is to build a common supervisory culture and a practical operational network of banking supervisors within the established EU legal framework. This is of particular importance for the efficient supervision of cross-border banking groups, as the appropriate dissemination of information relating to risks and the elimination (if possible) of work duplication are expected to reduce the administrative burden and costs for the supervised institutions, while reducing the strain on supervisory resources. This does not mean that there are no benefits for smaller institutions, with a predominantly domestic or even local focus, as convergence will imply the establishment of a level playing field across the EU.

Next steps

Changes in the regulatory framework and the organisational structure of the decision-making process are necessary but not sufficient conditions for the realisation of the EU financial market ' s strong growth potential. This can be more easily achieved if financial integration is accelerated. This belief is the driving force behind the new EU financial services strategy for the next 5 years, which is currently under discussion among the EU institutions, while, at the same time, market participants are being consulted.

Up to now, the elements that seem to be part of this strategy and are closely related to the banking sector are the completion of certain ongoing projects (i.e. mortgage credit, consumer credit, the New Legal Framework for Payments, etc.) and the undertaking of new legislative initiatives (i.e. investment funds, bank accounts, credit intermediaries).

One of the legislative initiatives that requires special attention is the proposal for a Directive on payment services. The proposed Directive, which is part of the wider Single European Payments Area Project, aims to establish a modern and harmonised legal and operational framework necessary for the creation of an integrated retail payments market, which would enable payments to be made more quickly and easily throughout the EU. The proposal also aims to introduce more competition in payment systems and facilitate the realisation of economies of scale. This will improve efficiency and reduce the cost of payment systems for the economy as a whole, an issue of high importance to the Bank of Greece, as electronic payments systems are not very much in demand in Greece.

Future challenges

Supervisory architecture within the EU

Lately, several discussions have revolved around the issue of the EU supervisory architecture, one of the arguments being that the complexity of supervisory arrangements increases in parallel with the growth of a banking group ' s cross-border activity. Without dismissing these concerns, we do not share the view that the conduct of cross-border activities is connected with a significant supervisory burden. On the contrary, the most important obstacles to the expansion of cross-border activity in the banking sector are the differences in the tax treatment of banking products among different states, cultural differences and the lack of proximity (except in the case of branches).

Different views on the supervisory architecture advocate alternative models of supervision, ranging from complete centralisation to total decentralisation. Each approach has its own merits, but also raises a number of complicated strategic and operational issues that need to be addressed.

I believe that in no way should extreme solutions be adopted and instead implement the Lamfalussy approach, which though is not a panacea, has the definite advantage of allowing for a lot of flexibility. First of all, it provides for a range of different degrees of centralisation in the regulatory process, which would entail a more or less harmonised set of rules depending on the issues that need to be addressed. In this way, it facilitates the swift adaptation of community legislation to new developments in the financial markets, which in many cases have cross-sectoral dimensions. Moreover, it boosts regulatory and supervisory convergence while at the same time allowing for the efficient handling of differences arising from the fact that the vast majority of the 8,000 credit institutions in the EU operate domestically and sometimes even locally, in markets with diverse characteristics and which can better be assessed by local supervisors, as the history of the last 50 years has taught us.

In this context, I think that we can go a long way with the Lamfalussy framework. And I do not think we are anywhere near the stage where we can say that we have fully exploited all the possibilities it has to offer, at least in the banking sector. In addition, the Lamfalussy framework and the way it is applied will evolve over time in response to the evolution of markets.

The Eurosystem’s perspective

I would like to conclude my speech with a specific reference to the Eurosystem's perspective of the above-mentioned regulatory developments. It is worth noting that the Eurosystem's primary relevant concern stems from the fact that it is responsible for monitoring financial stability in the euro area, and at the same time recognises that a smooth-functioning financial system is a vital transmission mechanism for ECB monetary policy.

Within this context, the forthcoming implementation of the new capital requirements framework, as well as the strengthening of supervisory cooperation within the EU, are seen as particularly encouraging developments, as they considerably enhance the existing financial stability framework.

Of course, as the financial market landscape changes and the degree of European financial integration increases, new concerns are likely to arise, regarding, for instance, the ability of the system as a whole to respond to a possible emergency situation in a timely and effective manner.

The Bank of Greece, as a member of the Eurosystem, keeps a close eye on developments, while participating actively in the respective discussions within the EU institutions for the establishment of common arrangements.