Nout Wellink: Banking supervision in Europe – developments and challenges

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the 36th Economics Conference 2008, held at the Austrian National Bank, Vienna, 28 April 2008.

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The banking system has gone through major changes over the past years. Underlying factors have been deregulation and liberalisation, as well as technological progress. Three main trends can be distinguished.

- First, banks themselves have become increasingly market-dependent. That is, we have seen a transition from the traditional originate-to-hold banking model to the contemporary originate-to-distribute model. Financial innovations, such as securitisations and credit risk transfer, have enabled banks to disperse their risks to the capital markets. However, as the financial turmoil has clearly shown, the transfer of risks has in many cases been inadequate. The currently ongoing re-intermediation process, which is hampered by a lack of market transparency, is putting strain on banks' profits, capital and liquidity cushions.
- Second, banks have increasingly embarked on international operations, primarily through subsidiary companies. As a direct result of a recent surge in cross-border banking mergers and acquisitions, the share of foreign banks in domestic European markets has increased substantially, from 26% of total assets in 2001 to 33% in 2006. Furthermore, the share of European banks' claims on the rest of the world has also grown.
- Third, the banking system has become more concentrated. Whereas the number of credit institutions in the European banking sector has declined, total assets have increased, signalling the emergence of larger institutions. As a direct result of numerous mergers and acquisitions, Europe's largest banking groups have been growing in prominence. Between 2001 and 2005 the largest banking groups' share in total EU banking-sector assets has risen substantially from 54% to 68%.

As regards the first trend of more market-orientation of banks, the recent turmoil has revealed that the originate-to-distribute model needs to be strengthened. The Financial Stability Forum has made several recommendations in this respect. Market transparency and valuation should be enhanced; risk management practices should be strengthened, especially with regards to liquidity risk; and, more fundamentally, incentives along the securitisation chain must become properly aligned. So, major challenges lie ahead. Let me elaborate on how the implementation of Basel II will support the adjustment process.

Basel II supporting banking system resilience

As you know, Basel II has only been fully implemented in Europe since the beginning of this year. The US is rolling it out more slowly. Even so, there is already strong agreement that Basel II will improve incentives for risk management and market disclosure and enhance capital regulation and supervision. Let me point out some key enhancements relevant to the current crisis. Among other things, Basel II will deliver better risk differentiation. Banks that enter upon more risky lending practices will need to strengthen their capital base accordingly. Moreover, under the new capital regime all exposures will be subject to regulatory capital charges, whether on or off the balance sheet. Basel II will also create more neutral incentives between retaining exposures on the balance sheet and transferring them to the capital markets through securitisations. It will reinforce capital requirements for banks' trading books, which are rapidly growing. And last, Basel II will enhance disclosures of banks' risk profiles, notably with regard to structured credit and securitisation activities.

Given that Basel II is a risk-sensitive framework, there is some concern that it may turn out to be too procyclical. However, to achieve more risk sensitivity in minimum capital, there has to be some fluctuation in that requirement over the cycle. The Basel Committee has tried to balance the objectives of risk sensitivity and capital adequacy over the cycle. For instance, banks are required to perform forward-looking stress tests to make sure that they hold enough cushions above the minimum. Basel II will also require much stronger firm-wide aggregation and management of risk exposures. And banks that take on more risk will be required to hold more capital in the first place, helping to prevent the build-up and underpricing of risk. We will also be tracking the framework over time and make any necessary adjustments based on our findings.

So, it is safe to say that the Basel II framework is a major improvement. But it is not the ultimate answer to the financial markets problems of today and tomorrow. In December 2006, the Basel Committee had already identified "pressure points" and weak spots in the regulatory and supervisory regime that should be addressed. Fortunately, the framework is flexible enough to evolve over time. In light of recent developments, the Basel Committee has already begun to evaluate certain aspects of the framework. These include issues such as the securitisation of complex products, reputational risk and disclosure. But strong capital, though essential, is only one aspect of a stable banking and financial system. Sound risk management, strong supervision and robust liquidity cushions are also critical. The Basel Committee's work agenda seeks to strengthen practice in these areas. It is in the process of finalising global sound practice standards for liquidity risk management and supervision. These will address many of the lessons learned from the market turmoil. The Committee will also work on stress testing, off-balance sheet management, and valuation practices. Furthermore it is enhancing market discipline through better disclosure.

Ensuring effective and efficient cross-border banking supervision

Let me now turn to two challenges related to the infrastructure of supervision in Europe, namely cross-border supervision and the interplay between central banks and supervisors. The former challenge follows from the internationalisation of the banking industry. Over the past decades, European banking groups have become increasingly international in character. Not only do they move more easily across national boundaries, they also organise themselves accordingly. Prompted by these developments, supervision has moved beyond its primarily national orientation. Indeed, supervisory rules and regulations are being progressively internationally harmonised – Basel II is in this respect a leading example. Nonetheless, internationally active banks are still confronted with a multitude of supervisors and regulators, which may impose their own specific national requirements. As the internationalisation of banks may be presumed to continue in the foreseeable future, further steps are needed to ensure effective and efficient cross-border banking supervision in Europe.

While a more integrated pan-European supervisory structure is ultimately desirable, how to get there is far from clear. Indeed, legal frameworks, deposit guarantee schemes, fiscal regimes and national supervisory arrangements within the European Union are still very diverse. The European Council agreed in December 2007 on a Financial Supervision Roadmap. Important elements of this Roadmap are the introduction of a European dimension into the mandates of national supervisors and the improvement of the functioning of EU colleges of supervisors.

Realistically, to promote more effective and efficient banking supervision in Europe in the near term, we should continue to build on the existing institutional structure. Accordingly, the challenge of cross-border banking supervision can be addressed in a two-step process. The first step is straightforward and can be taken swiftly. In line with the outcome of the latest informal ECOFIN and the recommendations by the Financial Stability Forum, so-called colleges of supervisors should be established for all major cross-border groups. These international colleges should include all relevant supervisors and would be created to enhance cooperation on ongoing supervisory issues. Existing supervisory committees such as CEBS should guard the coherence and consistency between the different colleges to preserve a level playing field for the industry as a whole.

The second step towards more effective and efficient cross-border supervision concerns the decision-making process in colleges of supervisors. Whereas decision-making in existing examples of colleges is entirely on a consensus basis, I believe that the role of the lead supervisor or consolidated supervisor should be strengthened in order to avoid stalemates. Both for efficacy and efficiency reasons, decision making in colleges should resemble the clauses on internal model validation in the Capital Requirements Directive. These call on home and host supervisors to agree but ultimately, if consensus is not reached, allow the home supervisor to decide. Let me emphasise that the lead supervisor model requires a close working relationship between the host and the home supervisor, in which the host supervisor is taken seriously. In practice, a distinction could be made between general colleges with broad information sharing, and core colleges with high frequency meetings particularly during periods of stress. A formal mediation mechanism could be considered to provide host supervisors a way to appeal against decision-making by the college or the lead supervisor. Besides more effective supervision, lead supervision will also promote greater efficiency. The financial sector's strong support for this supervisory model underscores this.

Ensuring effective interplay between supervisors and central banks

Besides effective and efficient cross-border supervision, another challenge is to ensure an effective interplay between banking supervisors and central banks. As European banks have clearly grown in prominence and wholesale markets have become closely integrated, problems at individual banks are more likely to have systemic effects. Consequently, it is difficult to draw a line, in practice, between the responsibility for systemic stability, including the function of lender-of-last-resort, and that for prudential supervision of large banks. Indeed, in today's increasingly market-based financial system, disturbances are likely to affect core market mechanisms.

In my view, there are two necessary conditions for effective cooperation between central banks and banking supervisors. First, a cooperative and open mindset is required. Second, close and continuous information sharing is necessary. For the execution of central bank functions, timely access to micro-prudential information on individual banks is relevant. In the financial turbulence, information on the liquidity arrangements of counterparties, their sources of funding, and on their financial position has proven to be essential to obtaining a clear picture of the liquidity pressures influencing banks. Conversely, the information central bankers have on the functioning of money and credit markets is indispensable for prudential supervisors when assessing the risks to individual banks. These two necessary conditions for effective cooperation between supervisors and central banks – cooperative and open mindsets and adequate information sharing – are most effectively met within "an institutional framework in which the Eurosystem's responsibilities for monetary policy in the euro area are coupled with extensive supervisory responsibilities of NCB's in domestic markets and with reinforced cooperation at a euro area-wide level". The Twin Peaks model of financial supervision is fully in line with this 2001 conclusion of the Governing Council.

Conclusion

In conclusion, the financial market turmoil has underscored the importance of resilient, well-functioning banking systems. The implementation of Basel II will help banks and banking supervisors in achieving this. Regarding the infrastructure of supervision in Europe, I believe cross-border supervision needs to be strengthened. Indeed, a major step forward can be achieved through the lead supervisor model. In the lead supervisor model, an adequate representation of host country interests is crucial. Regarding the combination of prudential supervision and central banking, recent events have shown there are important synergies and reinforced the arguments for bringing both responsibilities as close as possible together. To ensure effective interplay between supervisors and central banks, a cooperative and open mindset is required, as well as adequate and timely information sharing.