Willem F Duisenberg: The future of banking supervision and the integration of financial markets

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the conference organised by Euro Group entitled "Improving integration of financial markets in Europe", held in Turin, on 22 May 2000.

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I should like to thank the organisers for the opportunity to participate in this interesting event. We are here to discuss the important and profound changes taking place in the banking industry and financial markets worldwide. In Europe, these changes have been significantly intensified by the introduction of the euro. I wish to offer my remarks today on the issue of preserving financial stability for the euro area in this rapidly changing environment.

Ensuring effective banking supervision and crisis prevention plays a key role in this respect, and is facing challenges from two major sources: the internationalisation of financial activities and the geographical split between the jurisdiction of monetary policy and banking supervision. The monetary policy function now embraces the 11 countries that have adopted the euro, while supervision remains a national responsibility. This situation introduced by the Maastricht Treaty is a novelty; it does not have historical precedents.

It is the view of the ECB that the existing institutional arrangements can provide an adequate and flexible basis for safeguarding financial stability - also in the future. However, the practical functioning of supervision needs to be developed and cooperation between competent authorities needs to be enhanced in order to ensure the effective execution of supervision and corrective action in the increasingly integrated euro area financial system. Moreover, authorities should be able to take an area-wide - or even a global - view whenever the situation so requires. The desirability of these enhancements is also acknowledged in the recent report on financial stability prepared by the Economic and Financial Committee and endorsed by the ECOFIN Council at its meeting on 8 April 2000.

Let me proceed by describing in more detail the two challenges for supervision that I just mentioned. After that, I should like to evaluate the necessary steps for promoting adequate cooperation and coordination among the authorities concerned.

Increasing cross-border banking

There is no doubt that the introduction of the euro has fostered the internationalisation of banking activities. In particular, the rapid integration of the wholesale and capital markets, as well as large-value payment systems, has already produced more and new kinds of linkages among banks. As a result, banks are increasingly exposed to risks originating from abroad, and risks to financial stability are less and less confined to national borders.

The most substantial increase in cross-border activity and market integration has taken place in wholesale activities. For example, the currency-based segmentation of the markets for unsecured interbank deposits disappeared very quickly after the euro was introduced. The differences in quotation spreads across countries fell during the first weeks of 1999 to an average of around two basis points from significantly higher levels. These spreads are deemed to indicate normal thresholds, beyond which arbitrage is no longer profitable. Wider price differentials still prevail in the repo market, reflecting lower liquidity and remaining segmentation of the national markets owing to legal and other factors.

Market integration has not only been reflected in price quotations, but also in trading volumes. The share of cross-border transactions currently accounts for more than 50% of overall activity in both the unsecured and repo markets. Some large institutions are starting to act as "money centre" banks assuming an area-wide scope of activity. The smaller institutions still mainly operate with their domestic counterparts, but nonetheless benefit from the equalised market conditions. Accordingly, the share of cross-border transactions in the large-value payment transfers through the TARGET system has been increasing - from 36% in the first quarter of 1999 to 41% in the fourth quarter. The values exchanged cross-border are of substantial magnitude. The average daily value of TARGET cross-border payments is close to 400 billion euro, representing mostly interbank payments. In addition, a large amount of payments is channelled through EURO 1 (EBA) and Euro Access Frankfurt.

In addition to the single monetary policy and the creation of the single risk-free yield curve, two main reasons explain the rapid integration of the wholesale activities in the euro area - of the market for unsecured interbank deposits in particular. First, the smooth functioning of the settlement of cross-border payments, mainly performed through the TARGET system, allows banks to trade safely throughout the euro area. Second, the swift acceptance of euro area indices (EONIA and Euribor) forms a common basis for pricing. The experience with TARGET demonstrates the importance of the market infrastructure in allowing arbitrage to operate effectively. The unsecured market can rely entirely on TARGET for settlement, while no similar integrated system exists for the clearing and settlement of securities and for managing collateral at the cross-border level, relevant for repo transactions and for all securities transactions in general. For instance, there are currently 22 securities settlement systems in the euro area, facing increasing demands for consolidation.

The broadening of the market size and increasing share of cross-border transactions has had a positive impact on financial stability. If there were only a few market participants and the concentration of the interbank liabilities were high, the likelihood of a bank failure having stronger repercussions on the viability of other institutions would be greater. In addition, the wider euro area money markets can now absorb liquidity shortages more easily than before, as banks can borrow more readily from foreign institutions. However, if some banks should nonetheless enter into a distressed situation, the probability of the problem spilling over to other euro area countries is significantly greater than before. The wholesale market is a major channel of the transmission of potential financial instabilities. Moreover, the existence of a common framework for accessing central bank liquidity is tying together euro area financial institutions to a much larger extent than usually recognised.

Let me now turn from wholesale activities to banks' customer businesses. As European banks are typically universal banks, they combine at a single institution a wide range of products. The markets for these products have varying degrees of integration - some are already global or European, while others have remained national or even local. At least the major banks already operate in strongly internationalised markets for a number of their products and already have geographically diversified activities. This makes them subject to various influences originating from outside their national markets. Even if banks remain nationally based, they are increasingly subject to international market developments and the national tendencies are increasingly influenced by international developments. Hence, the usual argument that cross-border mergers and acquisitions are a necessary condition in order to achieve a more integrated and international banking system does not seem very strong.

In particular, many of the asset management and investment banking services are already quite internationalised, as the capital markets have taken strong steps towards integration and growth after the introduction of the euro. Banks' own securities holdings have also become increasingly diversified across borders. The trend has been quite strong for government paper, as well as for corporate bonds. The amount of instruments issued by other euro area governments rose by 38% in 1999, and those by firms located in other euro area countries by 23% in banks' portfolios.

To take an example of the financial services provided by banks in the capital market area, the leading underwriters of bonds issued by European firms are the major European banks, alongside the largest US investment banks. The "league" in which these players compete is clearly not a domestic one. Another example - which is especially telling of integration - can be drawn from the rapidly expanding new European markets for technology and growth companies. Underwriting the Initial Public Offerings (IPOs) of this type of firm is the kind of service where we should expect the greatest degree of national segmentation, since the companies are usually accessing the capital market for the first time - possibly as captive customers of local banks. However, the new listings during the first months of the present year show that in most cases a foreign institution was present alongside a domestic one.

There are significant economies of scale associated with the shift in the dimension of the capital markets from national to euro area-wide. This seems to have already been one significant motive behind the recent bank mergers and acquisitions, also in the case of the deals that have taken place within national borders. Although most mergers have been domestic, cross-border deals also increased in importance in 1999.

By contrast with the services provided to other financial institutions and large corporations, retail activities referring to personal customers and small and medium-sized firms are still quite strongly confined to national borders. Within the euro area, both lending and deposit-taking by banks are largely conducted with domestic residents - 91% of loans and 87% of deposits still refer to domestic counterparties. Nevertheless, internationalisation is also progressing in this area; the business with customers located in other euro area countries is growing faster than the domestic business in respect of all major balance sheet items of banks.

Separation of central banking and supervision in EMU

I should like to discuss next the relation between central banking and supervision in the new institutional framework defined by the Treaty. As I mentioned, the third stage of Economic and Monetary Union introduced a geographical separation of monetary policy and banking supervision - in addition to the possible functional separation of the two functions that already existed in some countries. This is the case because, for the euro area as a whole, banking supervision is now entrusted to institutions that have no independent monetary policy functions (even if they are central banks) and the Eurosystem has neither direct responsibility for supervising banks nor for banking system stability. The main risk entailed in this institutional setting is the potential absence of an area-wide perspective of the banking and financial sector for the euro area.

The national central banks continue to be strongly involved in the supervisory tasks: only in three euro area countries - Belgium, Luxembourg and Finland - is the national central bank not directly involved in banking supervision. In all other eight countries, they are extensively or even exclusively entrusted with banking supervisory tasks.

Let me be a little more specific about the role and interests of the Eurosystem. One could say that the Eurosystem plays the role normally reserved for the central bank in countries where it does not have direct responsibility for supervision - such as the Bank of England after the creation of the Financial Services Authority. In this context, central banks still maintain a vital interest in a stable banking industry and closely monitor its developments and major systemic risks. This stems from the fact that the banking industry is the key channel for the transmission of monetary policy, the counterpart of monetary policy operations, and the main provider of payment services, which all relate to the basic central banking tasks.

Therefore, the Eurosystem is keen to see its actions complemented by an effective conduct of the supervisory function by the competent supervisory authorities. Central banks are keen to be sure that supervision is conducted in such a way as to ensure that banking problems do not jeopardise the conduct of monetary policy. This interest is clearly recognised by the Treaty, which assigns to the Eurosystem and the ECB some tasks relating to prudential supervision and financial stability. The Eurosystem has the duty to “contribute to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system”. Given the separation between monetary and supervisory jurisdictions, this provision is clearly intended to ensure a smooth interplay between the two. In addition, the ECB must be consulted on any draft Community and national legislation in the fields of banking supervision and financial stability, and the ECB can provide, on its own initiative, advice on the scope and implementation of the Community legislation in these fields. Central banks are normally involved in the process of drawing up legislation relating to, for example, regulatory standards, safety net arrangements and supervision, since this legislation contributes crucially to the attainment of financial stability.

Moreover, in the event of a financial crisis, the possible provision of emergency liquidity assistance, which is the responsibility of the competent national authorities, may have an effect on the common monetary policy, which is the direct competence of the Eurosystem. To limit central bank interventions and the associated moral hazard problems, it is necessary for crisis prevention mechanisms to be in good shape. Also for this reason, the Eurosystem needs to be assured of effective banking supervision and crisis prevention. In general, the crucial issue is that the risk management systems of individual institutions guarantee their safety and soundness, and the supervisors should assure themselves of this fact.

Enhanced cooperation needed

At the moment, banking supervision relies on national arrangements that still show a wide range of features. Furthermore, the strategies for corrective actions in cases of bank fragility vary across countries. Having supervision located at a national level - closest to the institutions that can give rise to financial stability concerns - favours timely access to information and allows detailed monitoring of banks' activities. At the same time, the principle of cooperation between the responsible authorities is forcefully stated in the EU Single Market legislation, and several Directives establish a number of common regulations, in order to avoid the drawbacks of a fully decentralised approach vis-à-vis an increasingly integrated market.

Hence, we could say that cooperation is already a "second pillar" of the supervisory framework, alongside national competence. Bilateral cooperation has been established through a nexus of memoranda of understanding. In addition, supervisory forums for multilateral cooperation have been set up. The Banking Supervision Committee of the European System of Central Banks is the key present forum for this form of cooperation. It is composed of the representatives of the banking supervisory authorities of the EU countries, either forming part of the respective NCB or separate bodies, and the ECB. The Committee facilitates cooperation among supervisors and the exchange of information between supervisors and the Eurosystem, and assists the Eurosystem in performing its duties in this field. The Committee has already established its functions and developed activities in several useful fields. It has also published a number of reports dealing with the structural changes and systemic concerns in the EU banking system. Another forum for dealing with multilateral cooperation is the Groupe de Contact, a group of EU banking supervisory authorities which, for many years, has also discussed individual banking cases in a multilateral way, but at a lower organisational level than the high-level Banking Supervision Committee.

The need for multilateral cooperation has been strengthened by the introduction of the euro. In fact, I am convinced that the only way the supervisory function is able to cope effectively with the increasing integration and to bridge the potential shortcomings arising from the geographical separation of monetary policy and banking supervision, is for the competent authorities to enhance their multilateral cooperation.

What should be achieved through multilateral cooperation? Ideally, a situation should be reached in which the group of European supervisors works collectively as effectively as a single supervisor, when needed. This is required when the problems involved are area-wide - because of the institutions or markets involved - or there are concerns of systemic problems spreading across borders. Multilateral cooperation can also enhance the quality of supervision by examining common trends in the financial system that may not be revealed from the national perspective only.

We need to strengthen cooperation between supervisors and central banks to ensure that, if problems at a major bank or a financial group have contagion effects in other countries, this information is effectively distributed to the relevant authorities and - possibly - common solutions are sought. These developments were seen as vital in the recent report on financial stability prepared by the Economic and Financial Committee, which I have already mentioned.

I see the Banking Supervision Committee as a natural forum for the deepening of cooperation along these lines. It allows a smooth interplay between EU authorities involved in safeguarding financial stability and it is in a good position to address these issues, since both supervisory and monetary authorities need to be involved in the cooperation. The Bank for International Settlements is currently fostering the discussion of issues of common interest to supervisors and central banks from a global perspective.

The national differences in the tools and style of supervision are not harmful, as long as there is effective cooperation, which allows supervisors to exchange views and to select best practices. A greater convergence of supervisory practices needs to be pursued in order to increase the effectiveness of the instruments aimed at preventing instability in a more integrated market for banking services.

Another important tendency, which I have not addressed in my remarks, is the ever-closer linkages and blurring differences between banking and other forms of financial activity. In some countries - but not all - financial conglomerates have also gained important market positions. To this end, it is useful and reassuring that the EU Commission has started work in the area of regulation of financial conglomerates. Moreover, it has facilitated a round table discussion among the Chairs of the Committees of the different disciplines: banking, securities market and insurance.

Finally, it is important that the ministries of finance and supervisory authorities regularly exchange views on the adequacy and necessary adjustments of financial regulation - as they already do - in the context of the relevant European regulatory fora, as well as in the national context. Central banks also contribute to this area of work, as I have already indicated.

To summarise, the present institutional setting for banking supervision in the euro area can cope with the challenges brought about by the increasingly integrated banking and financial system, as well as the issues raised by the separation of monetary policy and supervisory functions. However, cooperation between competent authorities needs to be further stepped up in order to ensure the effective supervision and preservation of financial stability. Will the extensive cooperation necessary for the system to be effective actually materialise? I am confident that it will. Both supervisors and central bankers are well aware of the new environment in which their tasks and responsibilities now have to be performed.