Edgar Meister: Challenges for regulators in Europe

Speech by Mr Edgar Meister, Member of the Directorate of the Deutsche Bundesbank, at the Joint Bundesbank/BIS conference on "Recent developments in financial systems and the challenges for economic policy", held in Frankfurt, 28-29 September 2000.

I.

Ladies and gentlemen,

Developments in the financial system, and the associated issues relating to systemic risks, are of essential importance to both central banks and banking supervisors. For that reason, in particular, in eight of the eleven countries of the Eurosystem the central bank is either responsible for conducting banking supervision or plays an important role in it. A stable financial system and especially a stable banking system are preconditions to implementing monetary policy in the European System of Central Banks (ESCB) and are an indispensable prerequisite for any economy to function. In some cases, central banks provide emergency assistance to help otherwise solvent credit institutions resolve liquidity crises. Moreover, the central banks are involved in the clearing and settlement of payments and, due to the considerable systemic risks in that area, exercise an oversight function. This results in synergies which can be harnessed for prudential supervisory purposes.

Today, banking supervisory issues are addressed, and prudential supervisory regulations refined, primarily at the European and international levels. The most important innovations in prudential supervision are discussed and drafted in international committees.

The challenges to supervisors in the ever-changing European banking market are very multi-layered. Let me address just a very few aspects which I think are of exceeding importance. For years we have been witnessing a trend characterised by:

- Europeanisation and globalisation;
- consolidation; and
- computerisation of banking business.

This trend is exceptionally complex and has gathered pace over the last two years. Also, I would like to discuss the implications for the structure and operating procedure of banking supervisors.

II.

Ladies and gentlemen, the so-called "European Passport" for financial services has undoubtedly given a decisive boost to the integration of European financial markets.

For some years, there has been a pronounced and accelerating trend towards consolidation in the European financial system. The integration of the markets is thus taking place at a higher level, as it were. There are two sides to this process: the geographical aspect, and the question as to what business activities are being caught up in the wave of concentration.

In the analysis, one notices that so far, mergers and takeovers in the European banking sector have been taking place mostly on national markets. By contrast, cross-border mergers have been fewer in number, but have been more in the public eye due to the size and stature of the institutions involved. For example: in the Benelux region, the takeover of the Belgian Banque Bruxelles Lambert by the Dutch bank ING; in Scandinavia, the merger of the Finnish Merita Bank, Norway's Nordbanken and Denmark's Unidanmark to form Nordic Baltic Holding; and the recently announced merger of Germany's HypoVereinsbank and Bank Austria. One notable example of a merger beyond Europe's borders is that of Deutsche Bank with Bankers Trust.

What are the most important reasons why mergers have so far remained mostly within national markets?

- Mergers are more easily accomplished when they take place in familiar cultural surroundings, where the language and the legal framework - particularly the tax framework - are the same.
- In some cases, national mergers are a stepping-stone towards cross-border expansion.
- Up until now the home markets of the larger countries, in particular, have afforded sufficient opportunities for mergers and diversification, thus eliminating the urgent need to look across national borders.
- Differences in corporate cultures, which tend to cause friction, become more prominent in cross-border mergers, especially where financial institutions of countries with different banking systems are involved.

However, accentuated by the introduction of the euro, we may expect the number of pan-European mergers to go up. The primary aim is the desire of many companies to open up new markets and to strengthen their own European and global competitiveness; they consider size to be an important competitive factor.

It is difficult to come to a final assessment of these M&A activities since most of the effects will only surface in the medium term. Mergers of small institutions, in particular, contribute to a consolidation of the banking system, with positive stabilisation effects. By contrast, mergers and alliances among big banks may create structures which might be difficult to manage. The problem is magnified in the case of cross-border mergers. Extremely large banks and financial conglomerates spread out over relatively numerous countries present major challenges for supervisors. These structures require increased supervision.

It is hardly possible to reliably forecast today what the impact of mergers will be on financial market structures. A stronger focus on financial conglomerates is just as conceivable as a concentration towards core operations with marginal areas being spun off. Both trends can be observed, though the contours of the resulting structures are not yet clearly visible.

This will naturally affect the future of universal banks. Will they remain competitive or will they be pushed aside by specialised banks expressly aiming to make full use of comparative advantages? As I see it, the universal bank has a future. This future, though, may involve a stronger focus on core competencies both to utilise comparative advantages and to benefit from the advantages of risk diversification. Cross-subsidisation of less-profitable branches of business by profitable areas, as universal banks had a reputation for doing in the past, will probably become less and less viable given the competitive waters in which these institutions are now swimming.

Ladies and gentlemen, an additional element of structural change in the banking market - in fact, often their driving force - is enormous technological progress. Especially electronic banking, including electronic brokerage, is creating a brand-new virtual platform for competition. With the Internet, a distribution channel with low overhead costs has been created, which gives not only large banks but also small and new banks much greater opportunities than in the past to successfully jockey for position.

To win customers, banks no longer need a high-cost network of branches. The “bricks and mortar” banks of the past are facing competition from banks that serve their customers for the most part - and in some cases exclusively - as “virtual service providers”. This will surely not render the credit institutions’ network of branches obsolete; however, pressure to downsize and to close insufficiently profitable branches, which already exists in many countries, will intensify. The implications of the new opportunities are far-reaching. But in addition to the economic opportunities they afford, the new technologies and specifically the Internet also, of course, harbour risks.

In addition to strategic business risks, security aspects also play a key role. Supervisors are thus paying great attention to those developments and are confronted with special challenges in this area.

After all, the new media make it possible to offer financial services from anywhere, which means that potential customers, competitors and also supervisors cannot always tell where the provider legally domiciled is and whether or not the enterprise has already obtained a license.

Adding to these are changes in market conditions. For example, the new media considerably enhance the transparency of services and terms of business and thus have a major impact on demand.

Ladies and gentlemen, what is the effect of all these developments on competition? Technological advances, increased transparency and new providers will tend to heighten the competitive nature of the market, which in Europe is being reflected, for instance, in the continuing fall in interest-rate margins. However, the process of consolidation may lead to a degree of concentration which impairs competition, although up to a certain threshold competition is tending to increase. The situation is different throughout Europe. In Germany, at any rate, the five largest banks account for only 17% of the volume of domestic business. In individual business segments, too, it cannot be said that individual institutions have a position that impairs competition. By contrast, the degree of concentration in other European countries is much higher, reaching 60 to 80% in some cases.

III.

Ladies and gentlemen, supervisors naturally need to figure out how to react to these changes. This also involves coming up with an adequate prudential supervisory structure for Europe.

Europe's current banking supervisory structure rests on three pillars:

- harmonised regulations with mutual recognition;
- national responsibility for prudential supervision; and
- cooperation and coordination.

Banking supervision in Europe has always evolved to keep pace with developments and changes in the financial sector and, in parallel to the market, has in a sense followed its own internationalisation strategy.

To start with, the harmonised banking supervisory regulations characterised by mutual recognition within the framework of the European principle of home-country control are a key factor. In that area, significant overall progress has been made towards a single European market for financial services.

However, the intensive cooperation among supervisory institutions in the practical implementation of supervision is also of special importance. That is to say, we need a convergence of prudential supervisory practices. This is not only to give market players a "level playing field" at that level, as well, but also to take account of cross-border activities and to keep the administrative costs generated by different supervisory regimes low. To this end, home and host country supervisory authorities are stepping up bilateral cooperation by means of a series of memoranda of understanding.

This bilateral cooperation is joined at the European level by well-functioning multilateral cooperation agencies. The "oldest" group is the Groupe de Contact, which focuses on questions regarding the implementation of prudential supervisory regulations and practices. The task of the Banking Advisory Committee of the EU Commission is to discuss and observe regulatory plans and supplementary guidelines and to deal with issues of interpretation. The ESCB's Banking Supervision Committee was formed to enable multilateral cooperation between central banks and banking supervisors, with stress being placed on the analysis of systemic stability. The Round Table of Regulators in Brussels, where the chairpersons of the various sectoral agencies (banking supervisors, securities supervisors and insurance supervisors) are represented, deals with cross-sectoral supervisory issues.

With this framework of regulations, agreements and agencies, the current supervisory system can boast quite a successful record in the area of financial stability. The most recent crises on international financial markets, for example, have been overcome by the European banking sector without any problems.

At any event, according to the findings of the recently-presented “Report on Financial Security” of a high-ranking working group commissioned by the Ecofin council (also known as the “Henk Brouwer Report”), the institutional framework of EU banking supervision is sufficient, yet cooperation in practical prudential supervision needs further improvement.

Ladies and gentlemen, the functionality of today’s European supervisory model has thus, in principle, been recognised by this working group. However, critics say occasionally that with banking operations becoming increasingly globalised, national responsibility for banking supervision could pose problems in spite of harmonisation at the European level.

Thus, despite all efforts, there are still prudential supervisory areas where rules have not yet been harmonised, such as liquidity regulations.

The European regulatory framework for prudential supervision rests on the setting of minimum standards. This leaves room for individual nations to implement and apply these standards in conformity with their special situations. However, particularly this variety of supervisory practices may have an impact on competition. The aforementioned continued harmonisation of supervisory practices is therefore of high priority and is being undertaken with vigour.

Critics have also indicated certain competencies as being a weakness of the system. Thus, foreign subsidiaries of institutions are subject both to consolidated solvency supervision by the parent country’s home authority and to individual supervision by the competent authority in the host country. Legally dependent foreign branches, by contrast, are supervised in terms of their solvency solely by the supervisory authority at the domicile of the headquarters but, in terms of their liquidity, also by the supervisory authority in their host country. This requires additional time and effort for submitting reports. Relief could be given particularly by the already-envisaged transition from host-country to home-country liquidity supervision. Further harmonisation requires that a European Commission Directive be adopted.

Finally, the European supervisory system, which is still based on national legislation, is not always able to react with the necessary speed to new developments in the financial markets. However, this is not a supervisory problem as such but rather the consequence of the existing European legislative process, which should be accelerated wherever possible.

IV.

Ladies and gentlemen, I do think it has become clear that the question of an adequate supervisory structure for Europe is an extremely complex subject. Against this background, some banks and observers have called for a central supervisory authority in Europe as a sort of panacea. However, controversy reigns as to whether, and if so, to what extent supervision should be carried out by the European Central Bank or a separate European supervisory institution.

I tend to take a dim view of these proposals; in my opinion, they do not represent a real solution to the problem and would be less than optimal in view of the financial market structures. The establishment of a central supervisory authority does not automatically lead to a harmonisation of supervisory rules. Conversely, the rules can also be harmonised without a central institution being founded.

I feel that a lot of thought should still be given to further developing the European supervisory system; for the key measure of a supervisory model is its ability to effectively support the objective of system stability and to function efficiently. Moreover, it must also be politically viable.

We have already noted that there is still a rather wide range of different banking systems and financial market structures in existence in the EU. Thus, the underlying question is: should a supervisory system determine the market or should prudential supervision follow market structures instead? I tend to lean towards the latter. Of course, it is necessary to define a regulatory policy framework for the financial sector, too, since precisely this sector is of particular importance to the macroeconomy. However, a very large dose of sensitivity for the situation is needed in order to keep regulatory guidelines, either material or institutional in nature, from causing structural changes in the banking sector which do not yield any additional economic benefit.

And here is another question: is the integration of financial markets in Europe already at such an advanced stage that this warrants institutional reforms of banking supervision in response? I think not. Whereas in the meantime the European interbank money market has already reached a high level of integration, some segments of the market for banking and financial services still lack the necessary depth, efficiency and completeness. For instance, retail banking has largely remained a national matter due to continuing differences in tax structures, legal regulation and cultural backgrounds among EU countries.

Adding to that, there is the following question: would the EU member states currently be willing to give up more national sovereignty above and beyond monetary policy, say, by transferring prudential supervisory powers to a supra-national institution? A central supervisory authority would have to be equipped with sovereign regulatory and intervention powers. Would governments and the public be prepared to accept a bank in their country being shut down by a supra-national supervisory authority, thus placing claims on taxpayers at the national level, by means of a potentially necessary bailout? In an insolvency crisis, a European authority would be deciding how national tax revenue is used.

Another question that affects practical supervisory activity is this: does centralising supervision provide more systemic stability? As mentioned earlier, the focus of most banks' business is still on their home markets. And there, they are subject to their respective national supervisors, which can rely on especially profound knowledge of their country's legal framework and banking system. Cross-border issues are even today already being addressed in the various multilateral coordination bodies. The Europe-wide diversification of business activity must naturally remain under continued observation so that, if necessary, the supervisory system can be adapted accordingly.

The way I see it, the aim is not a centralised authority but rather an improved coordination of supervisory rules and practices. I am confident that the present supervisory system in Europe is capable of pressing forward with the necessary harmonisation of different supervisory methods and regulatory framework conditions in a dynamic manner. To be sure, there are still harmonisation gaps which remain to be closed. However, a centralised supervisory authority would be confronted with the same problem of having to take account of special national features in its regulatory framework owing to the still-heterogeneous banking systems in Europe. Therefore, the optimum minimum level of harmonisation needs to be defined. For the time being, at least, it seems questionable, in my view, whether a complete streamlining of all rules is necessary, particularly owing to the implications for competition and in light of the variety of banking systems.

V.

Ladies and gentlemen, what conclusions may we draw? As the analysis has shown, there are no simple one-size-fits-all solutions for an adequate supervisory model for Europe. I feel that the present supervisory structure is functionally viable. Naturally, it must constantly rise to new challenges and come up with suitable answers.

A gradual refinement of the tried and tested system seems more suitable than a "big bang" in the form of a new, overarching supervisory authority in Europe. Don't get me wrong - I don't fail to recognise the need for a rapid harmonisation of supervisory rules and practices in order to make the system leaner, to reduce the administrative time and effort on the part of banks, and to keep the playing field level in future as well.

Yet I feel it is necessary to go one step further at the European level. The existing coordination bodies have done good work. These forums should be strengthened instead of taking what is, in my opinion, the too-large and currently not viable step of creating new institutions. Strengthening these forums would give an added boost to the process of harmonisation. In the interests of financial market stability at the European level, it is necessary to put together systemic developments in the individual countries to form a whole. With the Banking Supervision Committee, or BSC, we already have a body that could cover that aspect. This committee can function as an "observatory of systemic risk" and as a coordination body for cross-border banking supervisory and crisis management issues.

Ladies and gentlemen, I am convinced that with such an evolutionary and flexible approach which does not create a precedent for any financial market trends and which will later open up different institutional opportunities, challenges to supervisors can be met successfully in future, too.