## Mark W Olson: The European Union’s financial services action plan

Testimony of Mr Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, U.S. House of Representatives, 22 May 2002.

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Thank you, Mr. Chairman, for the opportunity to speak today on matters relating to the operations of U.S. banking organizations in the European Union. This is a time of significant change within the European Union with the ongoing efforts to complete the single market in financial services.

I join with my colleagues here today in welcoming the European Union’s plans to make its market more efficient and transparent. The United States has always been a strong supporter of European unity as well as market reforms that eliminate unnecessary regulatory burden and promote better functioning of markets and financial systems.

The Financial Services Action Plan of the European Union includes proposals that are aimed at achieving these same goals. The FSAP involves a series of regulatory and legislative measures designed to achieve, among other things, a single wholesale European market; open and secure retail markets; and state-of-the-art prudential rules and supervision. To further these goals, a number of directives have been or will be adopted that deal with issues such as money laundering, investment services, implementation of new Basel capital rules and international accounting standards, and supervision of financial conglomerates. I will deal with the latter three areas later in my testimony. These directives, and all of the other measures being adopted in the FSAP, will affect U.S. financial services firms with operations in Europe.

The FSAP is intended to modernize and enhance the efficiency and structure of the regulatory regime for financial services within the European Union. To the extent that the FSAP achieves these goals, U.S. firms are well-positioned to offer innovative and efficient services to customers throughout Europe.

At the Federal Reserve, we follow with interest changes to foreign bank regulatory and supervisory systems and seek to understand how these systems affect the banking institutions for which we are responsible. This is especially important in the European Union, in which U.S. banking organizations have substantial operations. As of December 2001, 27 U.S. banking organizations operate in the European Union with aggregate EU assets of over $650 billion. Moreover, 66 EU banking organizations conduct commercial banking and other financial services in the United States with aggregate U.S. assets of over $1.7 trillion.

These figures demonstrate that globalization is not a new concept or recent process. As U.S. industry has expanded its foreign operations, U.S. supervision has had to evolve to take account of the fact that our banks operate in many different legal and regulatory environments. We have strengthened existing cooperative relationships with bank supervisors in other countries and established new ones as U.S. banks continue to expand their operations into other countries. At the Federal Reserve, we conduct bilateral consultations with individual authorities and participate in international groups of financial services supervisors. We engage our EU counterparts both bilaterally and through these groups.

The Federal Reserve and the other federal banking agencies participate regularly in the Basel Committee on Banking Supervision, which was formed in order to improve communication and cooperation among supervisors of internationally active banks. Some of the key achievements of the Committee include the 1988 Basel Capital Accord, which created for the first time an internationally accepted standard for assessing levels of bank capital. The Accord replaced an uneven system of national standards and has allowed banks to expand internationally on more competitive basis. Similarly, the Committee adopted its Minimum Standards for Consolidated Supervision in 1992, establishing the principle that a bank should be subject to a supervisory regime in which its financial statements are consolidated and subject to review by home country authorities. Both the Capital Accord and the principle of consolidated bank supervision have become the internationally recognized standards that bank supervisors should aspire to meet.

Nine of the member states of the European Union are also members of the Basel Committee and a representative of the European Commission participates as an observer. The Federal Reserve and eight of these nine EU countries, and a European Commission observer, also participate in the Joint

Forum, a group established by the Basel Committee, International Organization of Securities Commissioners (IOSCO), and the International Association of Insurance Supervisors (IAIS). The Joint Forum discusses issues arising from the operation of financial services conglomerates and has developed principles appropriate to the supervision of entities that operate within financial groups. These group meetings, as well as many working group meetings on specific issues, provide regular opportunities for U.S. regulators to meet and discuss issues of common interest with European officials.

In addition to regular meetings of international groups, the Federal Reserve has longstanding relationships with both national regulators in the European Union and staff of the European Commission. For internationally active banking organizations with operations in both the United States and the European Union, national supervisors may participate in joint examinations of particular institutions, confer with each other on specific issues and meet periodically to discuss an institution's operations or financial condition. Ongoing communication is recognized as critical for effective supervision. Home and host countries' interests are both furthered by dialogue and strong supervisory relationships.

Regular contact with Commission staff goes back to the 1980s when the EU considered and adopted its Second Banking Directive, aimed at promoting the internal market by establishing the so-called "European passport" for banks chartered in the EU. Under the passport, a bank chartered in one EU country is entitled to establish branches in any other EU country under the authority and supervision of its home country rules. Since that time, several U.S. banks have taken advantage of this early EU regulation by establishing a local bank in a European member state, which then used the "passport" to establish branches in other EU member countries.

European subsidiaries of U.S. banks are able to take advantage of the passport under the principle of "national treatment." National treatment generally means that a country provides parity of treatment between domestic and foreign-owned firms, resulting in equality of competitive opportunity. National treatment has long been the prevailing practice with respect to foreign banks operating in the United States and this practice was incorporated into statute in 1978 with the enactment of the International Banking Act (IBA). This principle has also been incorporated in various trade agreements to which the United States is a party, such as the North American Free Trade Agreement (NAFTA) and the General Agreement on Trade in Services (GATS). The EU member states are also subscribers to the GATS and consequently to the national treatment principle it contains.

Implementing national treatment can be difficult precisely because one country is trying to adapt its own legal and regulatory structure to a foreign firm that is incorporated in a different home country environment. This is a challenge the Federal Reserve has faced over the years as we seek to apply U.S. laws that were adopted for a system of bank holding companies to foreign banks that generally do not have a bank holding company structure. The United States also requires that a foreign bank be subject to comprehensive consolidated supervision by its home country supervisor before it can buy a bank in this country. Under this law, the Federal Reserve must evaluate supervision systems that are different from our own and yet ensure that we are fairly applying the principle of national treatment.

U.S. private sector firms may be concerned about new regulatory and supervisory initiatives in the EU because such proposals may require changes in existing operations and/or reporting standards. There may also be a concern that initiatives designed for European firms or industries would not properly take account of home country supervisory structures or regulatory practices. Foreign banks have expressed similar concerns about U.S. regulatory initiatives in the past. At the Federal Reserve, we have found that our open and transparent regulatory process is crucial in helping us to understand how our proposals affect foreign banks and where problems arise, and gives us useful information for evaluating the merits of particular complaints. We have at times proposed regulations on which foreign banks and their governments, including the European Commission, filed adverse comments. These comments helped us to reevaluate our regulations and to determine whether our supervisory and regulatory objectives could be achieved in a different way, consistent with the principle of national treatment.

With respect to the implementation of the FSAP in the European Union, the European Union has an obligation to ensure that the rules adopted are consistent with the principle of national treatment. It is our expectation that the European Commission and the member states will seek to do so. Federal Reserve staff has met with Commission staff to discuss a number of matters, including the application of the financial conglomerates directives to U.S. banking organizations. The Federal Reserve is committed to continuing the dialogue with the Commission on matters of mutual interest, both bilaterally and as part of financial markets discussions led by the Treasury Department. We understand that the Commission has begun to engage in industry consultation as part of the rule writing process and we endorse a process that allows all affected institutions, including those that are foreign-based, to participate actively in the process.

The FSAP has a far reaching agenda. I will comment briefly on three issues of particular interest to U.S. banking organizations. With respect to the conglomerates directive, we understand that the impetus for the directive came from the Joint Forum's principles for the supervision of financial conglomerates. The three parent bodies of the Joint Forum (the Basel Committee, IOSCO and the IAIS) were concerned that, although individual financial companies within a group might be subject to prudential supervision, the consolidated financial group might not be subject to appropriate oversight. This in turn could lead to relationships or transactions that could pose financial risk to the regulated parts of the group. The Joint Forum's principles were developed to help assure that there are no material gaps in supervisors' understanding of inter-affiliate relationships within a financial group that could ultimately result in financial instability. We understand that the EU financial conglomerates directive is concerned with this same issue.

In the United States, U.S. banking organizations have long been subject to consolidated supervisory oversight. We believe that the Federal Reserve's supervisory programs and practices for bank holding companies, including financial holding companies, are fully consistent with the requirements that are contemplated under the EU's financial conglomerates directive.

With regard to the capital adequacy directive that is being developed for credit institutions and investment firms in the European Union, we also believe that the ultimate product will not present difficulties for U.S. banking organizations. The European Commission is mindful of the work that is underway in the Basel Supervisors Committee to replace the existing Basel Capital Accord with a more comprehensive risk sensitive framework for assessing an organization's capital adequacy.

When the EU issued its capital adequacy directive for public comment in 2001, commenters raised concerns about the regulatory burden that would be imposed on institutions that would be subject to both the EU capital rules and the Basel capital rules at the national level. The EU committee responsible for the capital adequacy directive has recognized this potential burden and has taken steps to ensure that the EU directive is as consistent as possible with the final revised Basel Accord. Technical working groups of the Basel Committee have been communicating with the EU technical drafting groups with the objective of harmonizing the two frameworks to the fullest extent possible.

The most sweeping changes in the Basel capital initiative are intended for internationally active banking organizations. The EU capital adequacy directive is intended to apply to a much wider range of institutions, both those with international operations as well as those that are purely domestic. Thus, the capital adequacy directive will likely address EU specific issues for smaller institutions. Internationally active European banks currently are subject to the Basel capital rules as they have been adopted in individual countries, as well as to the existing EU capital adequacy directive. Some differences between the two sets of rules do exist. Supervisors, however, are aware of these differences and continually strive to minimize the associated regulatory burden on institutions. Because the Basel revisions and the EU capital directive revisions are underway in tandem with similar estimated time frames for completion, there is a good likelihood that the final products will be substantively and significantly more consistent than the current Basel and EU capital rules.

The FSAP also contemplates mandating adherence to international accounting standards. Currently, banking organizations in the European Union may prepare their annual financial statements in accordance with the accounting standards of the International Accounting Standards Board (IASB), U.S. generally accepted accounting principles (U.S. GAAP), and/or national standards. The use of U.S. GAAP is usually limited to those banking organizations or other companies whose securities are publicly traded on U.S. stock exchanges and are registered with the Securities and Exchange Commission. In many cases, these companies will also provide separate financial statements based on their national accounting standards and disclosure rules. The European Union will require all EU companies listed on EU exchanges that are currently following national standards to follow IASB standards by 2005 and will require those EU companies that currently follow U.S. GAAP to adopt IASB standards by 2007. The EU is also working to adopt international auditing standards for external audits of EU companies, including banks.

The IASB is now independent of the international accounting profession and independently funded. It has adopted many of the structural elements of the FASB in the United States, which are intended to promote an independent, objective standards-setting environment. Many senior American accounting experts serve on the IASB and its staff. IASB GAAP has many similarities with U.S. GAAP and the IASB plans to propose extensive enhancements to its standards later this year.

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations with the objective of improving market discipline and fostering stable financial markets. The concept of market discipline is assuming greater importance among international banking supervisors as well. The most recent proposal of the Basel Committee to amend Basel Capital Accord (called Basel II) seeks to strengthen the market's ability to aid bank supervisors in evaluating banking organizations' risks and assessing capital adequacy. It consists of three pillars, or tools: a minimum risk-based capital requirement (pillar I), risk-based supervision (pillar II), and disclosure of risks and capital adequacy to enhance market discipline (pillar III). This approach to capital regulation, with its market-discipline component, signals that sound accounting and disclosure will continue to be important aspects of our supervisory approach.

The Federal Reserve and the other U.S. banking agencies are also actively involved in the efforts of the Basel Committee to promote sound international accounting, auditing, and disclosure standards and practices for global banking organizations and other companies. For example, an official of the Federal Reserve Board is a member of the Standards Advisory Council that advises the IASB and its trustees on its projects, proposals and standards. The U.S. banking agencies have been active in supporting the Basel Committee in its work with the IASB's technical advisory groups to enhance the IASB's standards for financial instruments and bank disclosures and the Basel Committee's projects with other international groups to promote sound global bank auditing practices.

In conclusion, I believe that the European Union should be encouraged to continue its program to strengthen and modernize the rules under which financial services firms operate in Europe. This can only increase competition, enhance efficiency and contribute to economic growth in the EU and globally. We are pleased that the European Commission is broadening its consultation and comment processes on proposals being considered under the FSAP. Supervisory and regulatory measures benefit significantly from an open and transparent process in which affected companies may participate. We would expect that the European Commission and member state national authorities will apply the FSAP's measures to U.S. firms on a fair and national treatment basis.

U.S. banking organizations are dynamic and more than competitive with the rest of the world. Accordingly, we are confident that U.S. firms will benefit from a strengthened and more efficient European market for financial services.