## Stefan Ingves: Cross-border banking regulation – a way forward: the European case

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at the Conference on International Financial Instability: Cross-Border Banking and National Regulation, Federal Reserve Bank of Chicago, Chicago, 16 October 2006.

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### Introduction

It is an honor for me to address this distinguished audience on a very timely topic. I have spent many years dealing with distressed banks in my own and by now a large number of other countries. One conclusion I have drawn from this rather odd line of work is that efficient banking regulation is needed both to reduce the risk that banks run into problems and to minimize the externalities that arise if banks actually fail. At the national level, many countries – including my own – still need to implement regulations to ensure that these risks are fully mitigated.

Let me also take this opportunity to congratulate the organizers on their choice of subject for this conference. The importance of the international dimension of the regulatory set-up is growing steadily. It is only now that many banks are becoming truly cross-border, with substantial retail activities in several countries. At the same time banking regulation, in terms of supervision, oversight, deposit guarantee schemes and responsibility for financial stability, remains predominantly national. This imposes additional challenges for financial regulators. These challenges are particularly acute in Europe given the rapid growth of cross-border banks on that continent. However, the issues raised are of global concern.

With this in mind, let me start out by stating my main message but before doing so let me stress that these are my personal views and do not represent the official opinion of any institution. In my view we need to plan for a special body – let us call it a European Organization for Financial Supervision (EOFS) – to gather information and produce a coherent and consistent assessment of the risks in the major cross-border banks in Europe.

As you all know, a separate regulatory framework for banks is based both on consumer protection arguments and on financial stability considerations. Banks provide fundamental services to the economy but could be subject to bank runs. There are also large contagion risks in banking activities so that problems in one bank could easily spread to other banks. Here, I will concentrate on the financial stability perspective.

### Banking developments in the EU

Until not so long ago, most banks had a clear national (or local) character with most of the activities limited to one country. Sure, many banks have had international operations for many decades but that has typically been limited to wholesale markets and services to large corporations. Financial services to retail customers and small and medium sized companies (SMEs) have been provided on a national or local basis. In this setting the national character of the regulatory framework has been appropriate. Now this is rapidly changing, especially in Europe – but also elsewhere.

First, banks in different countries are increasingly merging and creating some genuinely cross-border banking groups, targeting retail customers and SMEs in several countries. There are now about 40 banking groups with substantial activities in more than three countries in Europe. Just to take few examples: Unicredit Group has, after the merger with Germany’s HypoVereinsbank, a market share of at least 5 percent (in terms of total assets) in Italy, Germany, Austria, Bulgaria, the Czech Republic, Hungary, Poland, Luxembourg, Slovenia as well as Slovakia. Barclays and Grupo Santander are major players in both Spain and the UK. Fortis and ING are both important in the Benelux region. Erste Bank is large in Austria, the Czech Republic, Slovakia and Hungary; KBC in Belgium and a number of eastern European countries. Nordea is central to the banking market in Sweden, Denmark, Finland and Norway.

Second, banks are increasingly dependent on the international financial markets for funding, risk management etc. The inter-linkages and contagion risk between banks are probably increasing even for the banks that stick to a purely national focus.

Third, many of the cross-border banks are progressively concentrating various functions, such as funding, liquidity management, risk management, internal controls, compliance, credit decision-making, auditing etc, to various centers of competence. As a consequence cross-border linkages are rising.

Fourth, with the increased cross-border specialization, the distinction between a branch and a subsidiary is becoming increasingly blurred. Subsidiaries are becoming less self-contained. If the parent bank of a cross-border banking group defaults, it is getting more and more unrealistic to assume that the foreign subsidiaries could continue their business as usual. It would take time to establish all the necessary competence to transform such a subsidiary to an independent bank. Also, the possibilities for the host country to successfully ring-fence the assets is diminishing given the speed at which funds can be transferred across borders. When there still is a clear legal difference between branches and subsidiaries with clear consequences for supervision, the distinction becomes less important both in practical and in economic terms.

Fifth, and as a consequence of this merger activity, the banking market in some countries is dominated by foreign banks. In the ten new EU member states, about 70 per cent of the banking sectors are foreign owned. In Estonia, foreign groups account for more than 90 per cent of all lending.

My worry is that the next financial crisis in Europe could have serious cross-border implications and not be bounded by national borders. As a central banker, I see it as a major responsibility to be prepared for such an event, both in terms of handling the acute problem and in finding more long-term solutions.

One reason why this cross-border development is more pronounced in Europe than in many other parts of the world is the long-term project of creating a single market for financial services in Europe. Let me be clear here. I strongly support this project. It has freed banking from its national restrictions and fostered a more efficient financial sector. It has created an environment to support higher economic growth. Cross-border banking should not be seen as an economic problem but rather a challenge for the regulators and supervisors. The problem is that the regulatory framework for ensuring financial stability has not adapted as quickly and as thoroughly as needed.

Let me stress that historically, regulatory and supervisory convergence across borders has taken time. It cannot be expected that the optimal regulatory set-up will emerge immediate when market conditions change. The single market for financial services in Europe has definitely changed the market environment for financial firms. Now it is up the regulators to do their bit.

## Regulatory challenges

The question is then how the regulatory and supervisory framework could be adapted to face up to a situation where some banks play important roles in providing banking services in several countries.

Let me – for the sake of argument – assume that a problem occurs in a major cross-border bank under the present framework in Europe. Apart from the challenges to solve a problem in a purely national bank it becomes both more important and more complicated to address such a crisis. There are a number of challenges.

The first challenge concerns the sharing of relevant information. For a cross-border banking group the number of authorities involved multiplies. As a consequence information sharing may be slowed down. Also, compared to purely national banks, many cross-border banking groups have a more complex structure. This makes the analysis and information gathering more difficult. The functional specialization of cross-border banks also complicates supervision and information gathering. If a cross-border banking group concentrates all its credit assessments in one country it will be difficult for the supervisor in another country to assess the risk of the bank in that country without efficient supervisory cooperation and exchange of information. Further, if the bank puts all its liquidity management in a third country, extensive information sharing will be needed in order for any supervisor to get the full picture of the group's total risks. In principle the parent bank – and therefore the parent bank's supervisor – should have a full overview but in a crisis, positions may change quickly and thus complicate the collection of all relevant information. Such extensive information sharing becomes acute in a crisis but is also necessary in the day-to-day supervision.

A second challenge is that conflicts of interest multiply. Banking problems can be very costly and the ultimate guarantee for financial stability can only be given by the government, since only the government has the power to tax. In most countries the deposit guarantee schemes are only able to finance the problem if it is confined to minor banks. For systemic problems, the government would have to intervene. With predominantly national banks, how this is done is fairly straight-forward.

With the emergence of truly cross-border banks the question is how to share the burden. To what extent would the taxpayers in one country be willing to support the depositors in another country? And to what extent would the depositors in the second country be willing to rely on the potential future support of the taxpayers in the first country?

A similar problem applies when a central bank considers providing emergency liquidity assistance to a cross-border bank. Such funding is inherently risky. If not, the market would typically be able to provide the funding. Such assistance is also likely to affect the entire banking group. What happens if a bank is systemically important in one smaller country but not in another perhaps larger country? The smaller country will probably have greater incentive to save the bank but may end up paying for the entire group, if the larger country refuses.

Also, there are conflicts of interest if the bank is reconstructed. Any such reconstruction is risky and it is therefore uncertain whether the taxpayers would be willing to take these risks in another country.

A third challenge is how to achieve joint assessments. In Europe, there is an agreement to share views and assessments if there is a crisis. However in my opinion, that is not sufficient. In a crisis, most countries are likely to present assessments that support their national interests. With the present supervisory set-up, there is unfortunately a risk that it will be time-consuming to achieve joint assessments, and time is a scarce resource, especially in crisis management.

A fourth challenge is how to coordinate decisions by the authorities. The central bank must decide whether to grant emergency liquidity assistance or not and occasionally a bank may have to be placed under public administration. All of these decisions have to be made at short notice and typically with limited information. For this to be effective there is a need for a clear line of command. For cross-border banks where many supervisors, many central banks and many ministries of finance are involved, this is complicated to achieve. Without prior agreements on responsibilities this is going to be even more complicated, and may very well lead to suboptimal solutions.

The potential inefficiencies are probably enhanced by the differences in language and legal structure. The problem is further inflated by the inter-dependencies between the different countries. The decisions by one authority will typically have repercussions in many other countries.

To alleviate these problems there are today many MoUs between the authorities in the different countries – both regional and on an EU basis. Such MoUs are important to foster cooperation and information sharing but are, in my view, not sufficient. They are not legally binding and address neither the need for joint assessments nor the underlying conflicts of interest. Instead they should be seen as an important first step in facilitating the handling of cross-border institutions. However we need to go further.

## Potential solutions

To address these challenges four potential solutions have been discussed in various fora.

The first is to establish supervisory colleges. The idea is to create specific standing committees for each individual cross-border banking group with representatives from the relevant supervisors. The recently proposed operational networks of the Committee of European Banking Supervisors (CEBS) can be seen as a first step in this direction. This is a good start but also generates a series of problems. The supervisory framework becomes very complex and scattered. Which supervisors should be part of which college? It could also undermine the likelihood of equal treatment among banks.

The second is to enhance the home country’s responsibility, by giving the home supervisor additional powers not only for the group but also for all its foreign subsidiaries. One agency would thus get the responsibility for assembling information, formulating a joint assessment and coordinating decisions for all subsidiaries as well as the group level. A general problem with this solution is that it does not address the conflicts of interest. Will the home country authorities take the situation in the host countries fully into account in their decisions? How will host countries that do not share the assessment or disagree with the decision act? Also, will the authorities in a host country be willing to delegate such responsibilities to an authority in another country?

A third proposed solution is an extension of the second alternative. In addition, the home country will get an explicit EU-mandate to take the interest of the other relevant countries into account in its assessments and decisions but it is not clear how this will work in practice. There is also an accountability problem with this solution. National authorities are both appointed by and accountable to the national governments and in extension to the national electorate. It may be difficult for a host country to hold the authorities in a home country responsible for a specific decision, even if its main effect is in the host country.

A fourth possibility is the pan-European solution where both the mandate and responsibility for supervision are transferred from the national level to the EU-level. This would imply the creation of a European FSA, as well as granting the ECB a role as Lender of Last Resort for cross-border banks. This solution raises a number of difficult political considerations. It basically means handing over a part of the sovereignty to the EU-level. Also, at present the EU has no supra-national taxing power, so some other formula on burden sharing would have to be found. Presumably the political obstacles for this solution are large. At least in the short run, this fourth solution is not realistic.

**Another approach**

With this background, I draw three conclusions. First, the present situation with a growth of cross-border banks – with some clear examples in the European region – combined with national responsibility for supervision and financial stability is not satisfactory. If we are hit by a critical crisis in one or more of the major financial institutions today, the regulatory and supervisory framework is not sufficient. Second, we need to move forward and find a modified framework before problems arise. My experience is that if a crisis hits an unprepared authority, the choice of solution will suffer. Third, we should move ahead gradually, since there are obvious political difficulties and it is uncertain what the first-best solution would look like. In a political world, it is difficult to achieve first-best directly. Instead we have to move stepwise and ensure that we have our compass firmly in our hands to ensure a move in the right direction.

To solve some of the problems of coordination of information and assessments, I propose the establishment a new pan-European body, a European Organization for Financial Supervision (EOFS). The idea is to create a separate agency to follow the major cross-border banking groups in Europe. The EOFS should only focus on the presently about 40 truly cross-border banking groups and not deal with the about eight thousand European banks with a predominately national character. The EOFS should have three tasks: It should gather information about the banking groups and their activities in different countries. Importantly, it should also create unified risk-assessments of each cross-border banking group. Finally, it should also oversee the activities and risks of these banking groups.

To achieve these tasks, there is a need for a separate agency, staffed with a sufficient number of competent employees. Initially, these employees could of course be recruited from the existing national supervisors. Also the staff of the EOFS would have to cooperate with the national supervisors.

I also want to stress that the EOFS should be an independent agency. This independence is important to achieve a division of labor and power. It should not be part of the European Commission and not of the ECB. One possible solution is therefore that EOFS is established directly by the EU countries and with an obligation to report to the European Parliament.

My proposal is therefore quite different from the existing CEBS-structure which is part of the Lamfalussy regulatory framework in the EU. Although some of the EOFS's tasks would overlap with those of CEBS, the focus is different. CEBS's main tasks are to advice the EU-Commission, to enhance supervisory co-operation and to contribute to convergence of Member States' supervisory practices. CEBS is therefore a regulator and not a supervisory agency. The EOFS would be much more of a supervisor with as main task to produce coherent assessments of the risks and vulnerabilities of cross-border banking groups.

In my view and to start out with, the EOFS need not have formal powers, with the exception that it should have the right to require cross-border banks to submit information. Formal supervision could still rest with the national supervisors according to the existing home-host arrangements and potential sanctions be decided by the national supervisors. In this respect, the EOFS should be limited to suggesting actions to the national supervisors. Furthermore, the work conducted by the EOFS does not replace the oversight by the national central banks. They still need to oversee the banks as a part of their mandate on financial stability.

The creation of an EOFS could, if the organization is successful, be seen as the embryo to a full-fledged European supervisor – a future European FSA. It is much too early to tell whether such a development is feasible. First the EOFS would have to prove that it can produce added-value in terms of information gathering and assessments with real supervisory resources beyond that of a talk shop.

To be honest, my approach is not without problems either. It would make the regulatory structure somewhat more complex and it would increase the regulatory burden on the cross-border banks by adding a new agency for reporting. However, in my view, we need to achieve a greater coordination of the information gathering and assessments. Sometimes you need to settle for the second-best solution when the first-best is not possible.

Given the problems that I have sketched, a natural question is why my proposed solution has a purely European focus. The growth of cross-border banking is not unique to Europe, even if the development of truly cross-border banks is accelerating fast in Europe – perhaps faster than in other regions. The reason for my European focus is that there is, within the EU, a common regulatory framework, which includes the establishment of joint organizations. One example is the European Monetary Institute, which was the forerunner to the ECB. There is also a tradition of using a gradual approach. One of the underlying long-term principles in the EU is the ever increasing integration through small successive steps. Therefore Europe is likely to be a good starting point for the establishment of such a supra-national supervisory framework for cross-border banks. In my view though, the underlying challenge is of global nature. My forecast is therefore that the timely subject of this conference will be relevant also for future conferences.

Thank you.