Edgar Meister: European financial supervision – next steps

Lecture by Mr Edgar Meister, Member of the Executive Board of the Deutsche Bundesbank, at the "Kangaroo group breakfast debate", European Parliament, Brussels, 29 March 2007.

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I

Ladies and gentlemen

I wish to begin by thanking the hosts for inviting me to today's "working breakfast". It is a particular pleasure for me to share with you some of my thoughts on the future of financial supervision in Europe.

The prime objective for financial supervisors is to maintain the efficiency and stability of the financial system. This is already a challenge at the national level and is increasingly becoming one in a European context as well. The key question is "What should be the optimum design of financial market regulation and supervision?" There is no easy answer to this question. However, there are some criteria we can list.

1. Supervision should be risk-oriented.
2. Priority should be given to principle-based rules over detailed regulations for every specific case.
3. Supervisors and their rules should place as minor a burden as possible on institutions – but still be effective to achieve the objectives pursued.
4. When developing prudential rules, supervisors should consult with credit institutions at an early stage in order to incorporate market expertise and to define rules which are consistent with market conditions.
5. Given open banking markets, prudential rules should be applicable throughout Europe and worldwide.

II

It is, of course, difficult to put these criteria into practice perfectly at all times. However, we have already achieved much in Europe. Let me cite some examples.

One is introduction of the Lamfalussy procedure: a precondition for speeding up and enhancing the efficiency of the legislative process in Europe by involving supervisory experts and the financial industry.

Measures aiming at "better regulation" recently tackled by the Commission are another important and proper step. These measures cover improving the legislative process, open and transparent consultations, impact assessments which include financial stability aspects, improved monitoring of implementation, better enforcement of Community law and *ex post* evaluations. This approach is widely supported by supervisors and the industry alike.

"Better regulation", in my opinion, needs to include granting a "regulatory pause". Considerable efforts have been made in recent years to create the regulatory environment for an integrated European capital and financial services market. However, these measures – especially the implementation of Basel II and the CRD – have placed, and are still placing, a substantial burden on the financial industry. Now, complaints are beginning to be heard from the industry about what it sees as a bureaucratic overreaction.

Therefore, only absolutely necessary regulatory projects should be launched. We should focus on implementing and consolidating the existing provisions. In doing so, we should ensure that this is done prudently and, as far as possible, in a "market-friendly" manner in order to avoid any unnecessary administrative burdens.

The new German Liquidity Regulation, which came into effect on 1 January 2007, is one example of such "market-friendly" regulation. This gives credit institutions, for the first time, the option of using their own internal liquidity risk measurement and management systems in order to limit liquidity risk for prudential purposes. Such internal procedures need to meet certain requirements, compliance with which is assessed by supervisors in an approval examination. Approval for institutions to use their own procedures eases the administrative workload of dual counting for the purposes of internal management and the purposes of supervision. This is a new approach – in an international context, too – and could well inject new life into the debate: both within the EU and among international standard-setters.

Another key issue is enhancing convergence in supervisory practice and cooperation between supervisory authorities in Europe. In banking supervision, this is one of the key tasks of the "Committee of European Banking Supervisors (CEBS). And CEBS has already made some progress and set things in motion in this area.

- **Supervisory Disclosure**: Publication of national rules, in other words: acts and implementing provisions, options and national discretions, criteria and methodologies of the Supervisory Review Process, and so on, on the CEBS website since the beginning of 2007.
- **Task Force "New Tools for Convergence**": this working group has been dealing with the development of new instruments to promote supervisory convergence, especially a mediation procedure for resolving potential disputes between supervisory authorities. Other aims include staff exchanges and training programmes designed to foster the emergence of a "common European supervisory culture".
- **Operational Networks** consisting of the line supervisors from authorities involved in supervision through a cross-border group of banks. The aim is to improve the flow of information exchange and cooperation, thereby reducing the supervisory workload for these institutions.

Close cooperation has also emerged in the area of stability analysis. Examples that come to mind are the work of the ESCB's "Banking Supervision Committee" (BSC) with its focus on analysing financial stability and structural developments, as well as the regular discussions at the "EFC Stability Table".

However, supervisors and central banks in the EU have also taken precautions for the event of a crisis. In 2003, for instance, the BSC reached an agreement on cross-border cooperation and on the exchange of information between supervisory authorities and central banks. In 2005, the finance ministries joined this agreement. To avoid any misunderstanding: we are not talking here about guaranteed financial assistance for individual institutions. All the institutions involved agree that responsibility for solving problems rests first and foremost with the market players themselves. Nevertheless, a framework for the better handling of systemic risks has been put in place.

III

Despite all this progress, there are still many items left on the agenda. Let me pick out three of them.

Europe's supervisory structures are under non-stop scrutiny. Just recently, the "Inter-Institutional Monitoring Group" presented its 2007 interim report on the Lamfalussy procedure. The report calls for greater efforts in making progress with level 3 supervisory cooperation – which, for banking supervision, means within CEBS. I rate this, first of all, as an endorsement of the cooperative model of supervision in Europe. That further efforts are needed is beyond dispute, and this is something of which all the responsible national supervisors are aware. What is important, however, is that these structures – which were created only a few years ago – are given the necessary time to achieve the consistent progress.

Even so, there are occasionally calls from some banks to move European supervisory structures in the direction of a "lead supervisor" or even a centralised European supervisory authority to supervise large institutions active throughout Europe. Most European banking supervisors[1], including the Bundesbank, have tended to be critical of this idea in their initial analyses. In its White Paper, the

[1] Callum McCarthy (FSA) says this about the idea of a "lead supervisor": "Instead of this approach, we should recognise that regulation of pan-European groups requires collaboration among regulators. We must be more efficient in how we go with this. But pretending we can achieve better European regulation by simply 'allocating' the task to one regulator is not the answer."

Commission, too, has advocated stepping up cooperation within the established structures and pressing ahead with the convergence of supervisory rules.

Still, please allow me to make some remarks on the concept of a "lead supervisor". In this supervisory model, the home-country supervisor responsible for the parent of a financial group would take on the function of a lead supervisor for all of the group's subsidiaries and branches as well as in all subsectors of ongoing supervision throughout Europe. Large European banks have repeatedly advocated this model recently. From the point of view of regulators, however, there are some implications that need to be borne in mind.

- Supervisors in the host countries of cross-border banking groups would sacrifice much of their competency and sovereignty, even though these banks are systemically relevant in their respective markets. This primarily affects the new EU member states.
- "Level playing field" issues would arise if large banks supervised by the home-country supervisor – for example, in the reference market – were governed by rules which differ from those applying to banks that are not active across borders.

On the issue of a "centralised European supervisory authority"[2]: this would be predicated on the existence of a number of conditions in order to enable effective and efficient supervisory activity. The most important – and especially problematic – aspects include

- Creating the conditions under European law to establish a centralised European supervisor, including amending the EC Treaties;
- Creating a single material supervisory (procedural) law;
- The absence of uniform insolvency legislation in the EU;
- The issue of creating a "two-class society" of financial institutions regulated by a European supervisor and those which are regulated by national supervisors yet simultaneously active in the same market.

We must not forget the far-reaching political implications, either. After all, national supervisors in Europe would have to hand over a large chunk of their political sovereignty. This also raises the issue of the democratic legitimacy of such a centralised structure. I believe that, so far, there has been too little or no discussion at all, of these aspects, which at the end of the day affect the question of a political union of European countries. Here, politicians have to achieve results before banking supervisors can work on designing a European supervisory framework.

IV

While talking about work in CEBS, I mentioned the concept of "mediation". This procedure originated in the securities field; in certain cases, mediation is governed by directives. The Market Abuse Directive, for instance, envisages mediation by the "Committee of European Securities Regulators (CESR)" in the event that, in a case of suspected cross-border market manipulation, one of the responsible securities supervisors refuses to turn over the necessary information. MiFID calls for using mediation in disputes concerning determining the most liquid market for a given financial instrument. At the initiative of politicians (Financial Services Committee, FSC), work is now under way on establishing mediation within CEBS as well.

Transferring a procedure that was designed for securities trading raises a number of questions. Unlike in the securities sector, in the banking field mediation does not have a legal foundation. Although mediation is voluntary, and its results legally non-binding, considerable "moral" pressure to abide by the results is likely to be created. Moreover, it is not just specific "cases" or "products" which are at issue in CEBS to become subject to mediation but large sections of supervision. It must also be noted

[2] On 27 March, ECON will probably adopt a report on the Commission White Paper on Financial Services Policy 2005-2010, which advocates, in surprisingly clear language, a centralised supervisor. In paragraph 34, ECON "[N]otes that for a real oversight of the systemic and prudential risks of the top players in the market, the present system of cooperation is too weak, and promotes a well-equipped executive European prudential supervisory authority inside that system endowed with the appropriate competences for supervision of large cross-border and cross-sector financial conglomerates".

that the competencies of the potential mediation parties differ in the field of banking, depending on whether they are home or host supervisors.

At the same time, the question of need for a mediation also arises in some areas. Thus, for instance, it is an option for approving group-wide risk-measurement procedures pursuant to Article 129 (2) of the CRD. However, CEBS has already developed "Guidelines on Validation" with the aim of reaching a common decision within the six-month period. Seen in that light, the use of meditation might be criticised as an example of excessive bureaucracy.

Mediation cannot – and must not be allowed to – undermine the European or national legal framework. Although areas such as "legal proceedings" and "national legislation" are not being envisaged as objects of mediation, the possibility of subjecting national discretion – and, thus, national legislation – to mediation has not been clearly ruled out, either.

Conclusion: careful thought should be given to the areas to which such a procedure is to be applied. Although mediation may help, it could also cause harm if the legal framework were abandoned entirely or interpreted too broadly. Mediation is not a new "Lamfalussy procedure" for adopting legislation but merely a tool for resolving disputes within the framework of supervisory cooperation.

V

Now, a few words on how to act in a crisis. Each crisis is different and therefore calls for flexibility in action. What is at stake is safeguarding the stability and efficiency of a financial system and, in some cases, also the use of taxpayers' money. The existing agreements take account of these factors. More extensive initiatives, going as far as to prescribe courses of action or even automatic mechanisms in the use of supervisory instruments, would miss the mark altogether.

A critical view should also be taken of *ex ante* "burden sharing" agreements in the event of a cross-border crisis. These are ideas of a more theoretical nature whose practical implementation would pose severe problems. Cost allocation rules would also involve setting certain steps in the decision-making process. Such *ex ante* agreements could lead to a far-reaching loss of political sovereignty and to interference in national budgetary sovereignty. In addition, the costs of crisis management are largely the result of discretionary decisions taken during the crisis itself, such as on whether to save or liquidate a company. It is therefore not possible to calculate the costs *ex ante*, and even an *ex post* calculation would pose problems.

VI

The conclusion we may draw is that the European cooperation-based supervisory system is currently a politically optimum structure under the existing conditions, by which I mean the absence of a political union. Supervision in Europe is well set up, cooperation is working efficiently and will be stepped up further.

Cooperation is the key! Cooperation between supervisory authorities, in other words: the supervisory colleges for the major banking groups, but also through common training, bears considerable potential for enhancing supervisory practice and reducing the costs of supervision to institutions. In a world of increasingly integrated markets, the institutions rightly expect this from us.

However, the integration of markets and the harmonisation of supervisory rules and practices are not goals in themselves. Integration should not be equated with uniform products and terms. Variety in the players' behaviour, products and markets is the way to address customer needs which are characterised by differences in cultures. It can also contribute to financial stability. Everyone doing the same thing or providing exactly the same products would increase the risk of "herding behaviour", which would potentially have undesirable effects for stability. Also, the process of financial market integration should be driven by the markets and not by regulators.

As I see it, excessive harmonisation or even complete standardisation of supervisory rules and practices would go beyond the current reality of market structures in Europe, especially in retail banking. Completely harmonised products in the mortgage lending sector, for instance, would be the wrong approach. In Germany, fixed-rate mortgage loans combined with prepayment penalties are an established practice for which there is a demand. It gives customers the certainty to make plans even beyond an interest rate cycle. The problems currently afflicting the US property market show the impact that variable rates in this segment can have on customers and, ultimately, also on financial stability. Stability should always be an additional consideration when devising regulatory measures. The limits of regulatory integration and harmonisation lie at the point where stability is put at risk!

Thank you for your attention.