Svante Öberg: Increased financial integration – future challenges

Speech by Mr Svante Öberg, Deputy Governor of the Sveriges Riksbank, at the Conference "Bank & Finance Outlook" (Affärsvärlden), Stockholm, 19 April 2007.

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Introduction

To begin with I would like to thank you for the opportunity to come here and speak about financial integration and the challenges this entails.

My main message today is that financial integration is increasing rapidly in Europe, and that this leads to better conditions for economic growth, but that it also means that regulations, supervision and arrangements for crisis management must become more international.

I have divided my speech into four parts. I shall begin with a brief description of financial integration in Europe in recent years. After that I shall discuss the advantages of greater integration. Then I will go on to talk about the challenges we face as a result of integration and conclude with some possible solutions to the problems.

It is a broad subject and we have very little time, so I will limit myself to the banking sector.

Financial integration

Traditionally, most countries' bank markets have been almost exclusively national. When banks have conducted operations abroad, these have primarily focused on large corporations and securities markets. Smaller companies and consumers have in principle been obliged to use the services offered by the domestic banks.

However, in recent years the bank markets have undergone major changes. Several European banks now offer their services outside of their national borders. More than 40 European bank groups have a substantial part of their operations in more than three European countries. Names such as Unicredit, Barclays, Fortis and ING are all examples of banks in the forefront of this development. The internationally-active banks are moreover increasingly offering services to households and smaller companies.

The integration process has been particularly evident in our own neighbourhood. Nordea and Danske Bank have substantial market shares outside of their respective home countries. With the exception of Iceland, it is in Nordea's case a question of market shares of more than 10 per cent in all of the Nordic countries. Swedbank and SEB are dominant actors in the Baltic region.

But financial integration is now also increasing rapidly in other parts of Europe. The timing of my speech could hardly be more appropriate. Only in recent weeks the media has reported on far-reaching plans for a merger between British Barclays and Dutch ABN Amro, two banks which together would become one of the world's largest players in this sector.

Parallel to this cross-border integration process there is also another type of integration within the banks. It is becoming increasingly common for these groups to organise themselves so that they in practice function as one bank instead of a number of independent bank companies. What drives the banks to change their organisation is the efficiency gains obtained through greater centralisation and specialisation. At the same time, the operations are woven together in a way that means that the different parts of the group become more dependent on one another.

Advantages

Increased financial integration in Europe involves economic advantages. Integration leads to increased competition. This in turn leads to companies and consumers being able to choose between a greater variety of products and to prices and interest rates being lower. More products make it easier to manage and diversify risks. Lower interest rates mean lower costs for borrowing, which is beneficial for both companies and households. Integration thereby means better conditions for economic growth.

The list of gains that integration brings could be made longer. But the advantages are well known to this assembly and I don't believe I need to go into this in more detail.

It is enough to emphasise that we at the Riksbank welcome increased financial integration.

Challenges

I will now move on to the challenges we face due to financial integration.

As the increased integration means that countries' financial markets become increasingly woven together, the risk increases that problems will spread between different countries. To counter this, new and greater demands are made to find joint solutions and to cooperate across national borders. Those days are gone when we could work on the basis of a purely national perspective for financial market issues. Now it is a question of finding ways to manage both our interests and those of other countries in a good way. This includes how we should conduct supervision, how we formulate regulations and how we organise ourselves to be able to manage financial crises, if these should arise.

In Europe, the EU cooperation gives us a joint forum for tackling this challenge. The EU's Financial Services Action Plan was launched in 1999. It has been a driving force behind the development I described earlier. The measures proposed in the action plan have now largely been implemented.

However, much remains to be done. This is evident when one looks more closely at the EC regulations that form the basis for the national frameworks for supervision and crisis management. The regulations we have in the EU at present and the way we organise ourselves is not adapted to the new conditions prevailing due to the increased integration.

One problem is that the responsibility for supervision is not adapted to banks with cross-border operations.

Within the EU the supervisory responsibility for banks is governed by the principle which in practice imbues all EC regulations in the financial field, namely the home country principle. This means, in brief, that the responsibility for supervision lies with the country where the bank is legally domiciled.

To illustrate how this works, we can imagine a bank with branch offices abroad. The bank and its branch offices are regarded as one single legal entity. They are therefore governed by the regulation and supervision that apply in their home country. How the operations are actually divided up between the different countries in principle has no relevance.

Danske bank is an example of a bank that has chosen to organise its operations in this way. The relatively extensive operations conducted by the bank in Sweden are largely under Danish regulations and supervision.

If a bank instead chooses the form of subsidiaries for its foreign operations, then its subsidiaries – as they are regarded as independent entities – will be covered by the regulations and supervision that apply in the respective countries in which they are domiciled. In this case, there are in a formal sense several "home countries".

Nordea's operations in Sweden, Finland, Norway and Denmark are organised in this type of subsidiary structure, which means that the group is covered by four different systems of regulation and supervision.

In both of these cases there is reason to ask whether a pure "home country principle" is the best basis for supervision of banks with considerable operations in several countries.

In the case of Danske bank, where the foreign operations are conducted in the form of branch offices, the most important question is whether it is reasonable and appropriate that the responsibility for supervision is concentrated to one single country. This question becomes particularly relevant if the bank is a large actor outside of the home country and in these countries plays a decisive role in the stability of the financial system. In the case of Danske bank's Swedish operations, one perhaps cannot say that this is currently the case. However, it is not inconceivable that this situation might arise in the future. The situation would be even more critical if the bank was at the same time a relatively small actor in its own country. In this type of situation the supervisory authority in the home country – which in this case is the one that decides – would probably consider that the need for supervision was not as great as the other countries might consider it to be. There is an evident risk of a conflict of interests between the countries.

There are elements of similar problems in the Nordea case, too. However, here the problem is rather the opposite – namely that the bank group's different companies (parent and subsidiaries) would be covered by supervision in several countries. The fact that each cross-border bank group has to obey and report to several supervisory authorities leads to additional costs and administrative duties for the bank. This is an obstacle to continued integration and to the competitiveness of the European bank market.

Another problem is that there are no common arrangements for crisis management within the EU.

Basically the only EC regulations defining how responsibility should be divided between the countries in the event of a cross-border crisis are regulations for compensating depositors in the case of bank failures. However, these regulations are not primarily intended to ensure efficient crisis management. They should rather be seen as protection for consumers.

The fact that the allocation of responsibility between countries in the event of cross-border crises is in principle unregulated leads to at least two serious problems.

Firstly, it lays the foundation for the conflict of interests I just described. Even if the responsibility for crisis management is formally unregulated, it will unavoidably fall to the country whose economy is to a large degree dependent on the bank that is in distress. This country is not necessarily the same country that has the responsibility for supervision of the bank. One consequence could thus be that a country which is substantially influenced by foreign banks could be forced to pay the bill for unsatisfactory supervision exercised by another country. The lack of a formal link between responsibility for supervision and crisis management is in this case an evident problem.

Secondly, the unregulated allocation of responsibility for crisis management means that each country that is involved in a cross-border crisis is thrown upon its own national crisis management and on the goodwill of the other affected countries in contributing to efficient crisis management. It is far from certain that this will lead to the optimal solutions. Without uniform regulations, forms for cooperation or mechanisms for joint decision-making, there is a considerable risk that we will find ourselves in "game-like situations" where the countries involved act in various ways to avoid paying the crisis "bill". In this type of situation there is a clear risk that all parties involved will be the losers.

This is a problem that affects not only the governments and authorities in the countries suffering crises. The arrangements for crisis management, like the supervision, affect the business conditions the banks work under. An efficiently-functioning safety net comprises a form of "quality label" on the bank system. This in turn has significance for the banks' ability to attract customers and financiers. If legislators and authorities cannot supply this, the domestic market will lose out in competitiveness compared with other markets. The fact that there is currently a lack of joint regulations for crisis management within the EU is therefore a problem, also from the banks' perspective.

Possible solutions

I have now come to the fourth and final part of my speech, the part about possible solutions to the problems.

Regulations, supervision and crisis management need to be developed so they can function even when banks have cross-border operations. The aim is to form a framework that can supply the need for financial stability, both nationally and internationally. It is equally important to ensure that regulations and institutional arrangements are designed so that the financial integration process can continue and the competitiveness of the European bank sector can thereby be strengthened.

Considerable thought is being put into these issues at EU level right now. Some measures have already been taken. For instance, the need for a more efficient and uniform supervision of banks with cross-border operations has partly been met by giving the supervisory authority in the group's home country strengthened powers and increased responsibility for coordination. To improve the exchange of information and the cooperation between the authorities in different countries, special agreements have been signed between the EU member states. In addition, various work is being done to ensure that the member states implement and apply relevant EC regulations in a uniform manner.

All of this is good, of course, and is aimed at managing the problems and challenges I have taken up here today. But it is far from sufficient. I do not intend to go into any detailed suggestions of how the various problems should be resolved. Instead, I would just like to convey – as a contribution to continued discussions on this subject – some general thoughts on how we can proceed.

In the short term, we should make improvements primarily in three areas:

Firstly, we in the EU should develop joint regulations for crisis management, which link together the responsibility for supervision and crisis management in a good way. The ultimate driving force to achieving efficient and appropriate supervision is, after all, the knowledge that one has to bear the consequences of deficiencies in supervision.

Secondly, we should improve and deepen the exchange of information, cooperation and coordination between the authorities in the different countries. At present there is, for instance, no common model as to how supervisory authorities can work together. Such a model is necessary to maintain high quality and efficiency in the supervision of complex banks with operations in several countries. An expanded cooperation can hopefully also contribute to harmonisation of the supervision that goes further than what can be achieved merely through joint regulations.

The agreements that I have mentioned earlier are aimed at achieving this. But it is doubtful how well these voluntary agreements will function in an acute crisis situation. To ensure efficient supervision and crisis management the content of the agreements needs to be formalised. An important part in this is finding methods of resolving differences of opinion between authorities.

Thirdly, we also need to work to reduce the introduction of national special regulations in the EU's member states. Of course, there must still continue to be scope for countries to formulate regulations on the basis of their domestic conditions. However, this impairs the prospects of bringing about a true harmonisation. It is therefore important to constantly question the need for national solutions in the regulatory work within the EU. The aim should be to reduce national deviations as far as possible.

In the long term, more in-depth structural changes will be necessary. This primarily concerns establishing joint institutions for supervision and crisis management at EU level. It may mean creating a supervisory authority for the 40 or so banks that currently conduct extensive operations in several European countries. It may also be a question of acting to create a joint European deposit guarantee scheme for cross-border banks. Such a system would have several advantages. Above all, it would mean that individual countries were not forced to pay large compensation amounts to depositors in other countries.

I am aware that this type of suggestion is far-reaching and controversial. It would mean a transfer of power from the member states to the EU. But the suggested arrangements would only apply to the banks conducting cross-border operations of sufficiently large scope to warrant EU-wide measures.

The main advantage of such a "supranational" arrangement is that the public frameworks for regulation, supervision and crisis management can correspond to the actual structure of the financial market. When supervision and crisis management are centralised, this also creates the conditions for reducing the administrative burdens on the banks and at the same time managing the risks where they actually arise. Both the banks and the individual countries would be the winners in such a system.

Conclusion

My main message today has been that financial integration is increasing rapidly in Europe, and that this leads to better conditions for economic growth, but that it also means that regulations, supervision and arrangements for crisis management must become more international. Financial integration provides us with a number of new challenges and we must work together to find solutions to the problems that arise.

Thank you!