Jean-Claude Trichet: Towards the review of the Lamfalussy approach – market developments, supervisory challenges and institutional arrangements

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the First CEBS Conference, London, 9 May 2007.

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Ladies and gentlemen,

It is a great pleasure for me to be here today at the first conference of the Committee of European Banking Supervisors (CEBS) and to share with you some thoughts at this particular time when market developments are underscoring the importance of making rapid progress towards a convergent supervisory framework. Not least, this time is also appropriate for such an exchange of views given the upcoming assessment of the functioning of the Lamfalussy approach.

Let me begin by recalling that the ECB has been a strong supporter of the Lamfalussy approach from the outset, i.e. since 2001, when this new institutional framework for financial regulation and supervision was first introduced. We also welcomed the extension of the approach to all financial sectors with a view to reaping the expected benefits, across the entire financial system, of more flexible and transparent legislative procedures and greater regulatory and supervisory convergence and cooperation. Since then, the ECB has been closely monitoring the efforts to enhance the EU framework for banking supervision. It is now time, as the CEBS completes more than three years of successful operation, to take a step back to evaluate the progress that has been made and to identify the key issues on the way forward.

I will organise my remarks in three parts. In the first, I will analyse some developments in the EU banking sector with a particular focus on integration and cross-border banking activities. I will then review the main objectives and related challenges for the supervisory framework in relation to these market developments. Finally, I will assess the progress achieved with the supervisory responses so far and point to some elements of the way forward.

Developments in the EU banking sector

Among the many developments in the EU banking sector over the past few years, I would like to highlight two, given their relevance for the supervisory framework.

First, the process of **financial integration has advanced more slowly in the banking sector** than in other segments of the financial system, namely the money, bond and equity markets. This is also supported by the findings of the ECB's report on "Financial integration in Europe", which we published for the first time at the end of March. The evidence presented in the report shows in particular that the retail component of banking business is the least integrated. Looking at price-based indicators, the cross-country dispersion of bank interest rates has remained relatively high, in particular for consumer loans (160 basis points). As to quantity-based indicators, while the cross-border component in banks' capital-market related and interbank holdings has increased over time – reaching 51% and 33% in 2006 – the respective share in loans to corporations and households has more or less stagnated, accounting for only 4% in 2006.

As we know, the pursuit of further integration in retail banking, and retail finance more generally, is one of the main objectives – fully shared by the ECB – of the European Commission's financial services policy in the coming years, as evidenced also by the recently issued Commission's Green Paper on retail financial services. While the achievement of the financial integration objective is fundamentally a market driven-process, public action is also required to establish and preserve a favourable framework. In this context, the supervisory setting in the EU is one factor – although not the only one – which is necessary to permit and facilitate further banking integration.

Second, the **internationalisation of EU banking groups has increased** in recent years. This has resulted, to a large extent, from cross-border mergers and acquisitions within the EU. The share of such transactions in the total value of M&A transactions performed by EU banks has risen to 36% in the years 2005-2006, from an average of 19% in the four preceding years. This intensified cross-border M&A activity was largely driven by some key, large-scale transactions. One can easily recall, to mention just a few, the acquisition of HypoVereinsbank by Unicredit in 2005 and the take-over of Banca Nazionale del Lavoro by BNP Paribas in 2006.

In this context, it is interesting to consider also the findings from a mapping exercise of **EU banking groups with significant cross-border activity** which has been carried out by the Banking Supervision Committee of the European System of Central Banks for the years 2001, 2003 and 2005. While the number of the groups included in the analysis increased only slightly – from 41 to 46 between the years 2001 and 2005 – the consolidated assets of the sample as a whole grew by 54% during this period, and its share in overall consolidated EU banking assets increased from around 54% to 68%. This indicates that EU banks with significant cross-border activity hold a sizable – and rising – share of total EU banking assets.

As one looks at the data in more detail, it emerges that the intensity and geographical scope of foreign activity varies considerably among banks. A simple measure of this, referring to the banking activity performed within the EU and based on 2005 data, shows that only **16 banking groups** out of 46 hold at least 25% of their EU assets outside their home country and are present in at least 25% (i.e. six) of the other 24 EU countries. These 16 groups – which could be labelled "key cross-border players" – account for around one-third of total EU banking assets, hold on average 38% of their EU assets abroad and are present in almost half (44%) of the other EU countries. This indicates that there is ample room for further intensification of cross-border banking activities in the EU. The EU supervisory framework has an important role to play in this regard. Let me elaborate on this aspect.

Supervision of cross-border banking groups

A first consideration is that **the supervisory framework in the EU should be supportive of a market-led process of cross-border banking as a driver of further banking integration.** Cross-border banks may act, via their expansion across jurisdictions, as important drivers in the financial integration process and thus contribute to enhancing the overall efficiency of the banking sector. The supervision of cross-border banks is performed mainly on a national, stand-alone basis, which results in a large number of partially overlapping and also potentially diverging requirements, thereby raising the costs for banks. Moreover, cross-border banking expansion has taken place predominantly via the establishment of foreign subsidiaries rather than branches. For the key cross-border players, for instance, foreign subsidiaries account for 60% of total assets held abroad. This increases the overall cost of supervision, given the evidently more far-reaching responsibilities and the correspondingly closer involvement of supervisors. Therefore, efficient supervision at group level should be pursued, through consistent supervisory requirements and approaches and closely coordinated measures to fully exploit synergies.

A second consideration is that **the supervisory framework in the EU should maintain its effectiveness in safeguarding financial stability** in a more integrated banking and financial sector. When the EU arrangements for financial supervision were established, the underlying premise was that potential disturbances at a bank would remain largely confined to the national level. We all agree that this assumption no longer holds. Indeed, given the rising intensity and scope of the foreign activities of EU banks, their growing degree of functional integration and the importance of intra-group exposures, financial difficulties affecting individual group entities may spread beyond national boundaries, and not only within the respective banking group but also across banking groups and financial systems.

While it is recognised that measuring these potential financial stability implications is a very complex issue, a simple way to gauge the importance of cross-border banking groups' operations for their home and host countries is to look at their respective local market shares. In their eight home countries, the 16 key cross-border players have on average an aggregate market share of 35%, ranging from 16% to 64% of total domestic banking assets. In the host countries a more mixed picture emerges. In eight host countries the key cross-border players hold on average an aggregate market share between 37% and 63% of domestic banking assets. In nine host countries, the average aggregate market share is still important, accounting for 10% to 29% of domestic banking assets. Finally, in eight host countries, the average aggregate market share is at a lower level, ranging from 1% to 9%. Overall, in 60% of all EU countries at least one of the key cross-border players accounts alone for more than 15% of domestic banking assets, and the average market share of the group with the greatest activity in these countries is 26%.

These elements support the need for enhanced cross-border supervision at the group level. In particular, intense cooperation and information-sharing is required, as both home and host supervisors increasingly depend on input from their peers on developments in other group entities to adequately assess potential risks that may affect the safety and soundness of the group as a whole or of its individual components. Furthermore, supervisory measures should be more closely coordinated to ensure the overall effectiveness of supervisory action.

A third consideration is that the pursuit of the two supervisory objectives I have just mentioned is a **challenging and complex endeavour**. I would like to highlight four issues in this respect.

First, the increasing intensity and scope of the foreign activities of EU banks inevitably leads to additional practical challenges for supervision at cross-border level, which in turn increases the need to ensure convergence of day-to-day supervisory practices.

Second, it may at times be difficult to resolve differences of opinion stemming from different attitudes of supervisors. For instance, progress in supervisory cooperation and convergence may require different degrees of adjustment in the supervisory frameworks of the concerned countries, given their varying starting points. Moreover, the time and resources devoted by supervisors to improving cross-border supervision may vary, depending on the particular structure of a banking group and the geographical distribution of its activities.

Referring again to the key cross-border players, there are host countries with large domestic banking systems, where a foreign establishment is very important for the group as a whole – accounting for 20% to 40% of total group assets – while it is much less significant for the host country concerned. Conversely, there are cases where a foreign establishment holds more than 20% of the respective host country's banking assets, but accounts for less than 5% of group assets. This phenomenon presents itself especially in smaller host countries. But it could become more widespread if the recently observed trend towards large scale cross-border M&A operations with major domestic players in the host countries continues in the coming years.

Third, there is an increasing need for co-operation between EU and third country banking supervisors. This stems from the fact that the more internationally active EU banking groups perform a significant part of their foreign activities not only within the EU, but also in other countries. For instance, the foreign assets held by the key cross-border players in non-EU countries account on average for 29% of the total foreign assets of these groups, reaching up to 53% in one case.

Finally, there is a need also for enhanced co-operation between supervisors on a cross-sector basis, given that many EU banking groups are active in other segments of the financial system, namely insurance and securities. For instance, seven out of the 16 key cross-border players have also been identified by the European Commission as "financial conglomerates" in accordance with the Financial Conglomerates Directive.

Progress to date and the way forward

I would like now to move on to the question of how the work of the CEBS has contributed to pursuing the objectives I mentioned earlier for the supervisory framework in the EU, namely to support further cross-border banking activity and to maintain its effectiveness in safeguarding financial stability. Overall, we can all agree that the CEBS has carried out in a relatively short time a remarkable amount of work to foster greater convergence of supervisory requirements and approaches.

In the first instance, we can say that the CEBS has contributed significantly to the preparation of an **impressive set of supervisory guidelines** which are relevant in general but in particular for the activity of cross-border banks. This contribution is related primarily, but not exclusively, to the supervisory implementation of the Capital Requirements Directive, covering the main elements of the first and second pillar of the new capital adequacy framework. The CEBS guidelines on the validation of internal-ratings based approaches and home-host cooperation are important pieces of this work aimed at fostering a more coherent approach to cross-border supervision at the group level.

I am aware that there are different views on the extent to which the CEBS has made progress in some areas in the pursuit of common supervisory frameworks. The common supervisory reporting developed by the CEBS for banks' consolidated financial statements and solvency requirements is frequently mentioned as an example of an area where it could have achieved more. In this respect, I would highlight two aspects to place things in the right perspective. First, it is difficult to express an objective judgement about success or failure in the field of supervisory convergence in the absence of an agreed and shared notion of convergence. Second, the process of convergence is challenging also because of the large variety of supervisory approaches at the outset.

In the second instance, the CEBS has undertaken initiatives to ensure that **the application of the supervisory guidelines is consistent in practice**. This is a challenging objective but also one which is crucial to determining the effects of the work on supervisory convergence. The CEBS has been working effectively on many aspects which are important for the implementation phase, such as supervisory disclosure, supervisory culture and the networks of competent supervisors. I regard the establishment of operational networks as a major initiative in this respect, but we should also be aware that it will take time to deliver results, given the complexity of supervising cross-border banks.

Overall, the work conducted so far by the CEBS to establish a common set of supervisory guidelines and the tools to promote their consistent application across countries is to be assessed in positive terms. However, we should remind ourselves that the pursuit of supervisory convergence in practice is unavoidably a long-term project and thus it will be of great importance to keep momentum in the process. To that end, I believe that all relevant stakeholders will have an important role to play along the following lines.

First, I would underline that the ability of the current arrangements to deliver results in terms of improved cross-border supervision **ultimately depends on the institutional setting**. As we know, the CEBS is not an institutional body in its own right, but a network of national authorities. While the CEBS – as well as the other Level 3 committees – is accountable for its achievements towards supervisory convergence at EU level, through periodic reporting to the Financial Services Committee and the European Parliament, its members are ultimately accountable to their national constituencies. Although so far the CEBS members have demonstrated a strong commitment to supervisory convergence and cooperation, a gap could emerge between aspirations towards further progress in this area and the national mandates of the supervisory authorities.

Ultimately it will be the continuous commitment of Member States to the objective of creating a sufficiently coherent EU framework for banking supervision which will determine the success of the overall efforts of the CEBS. Against this background, Member States may wish to consider whether the present entirely non-binding approach to supervisory cooperation will be sufficiently strong to respond to the growing challenges of effective and efficient group supervision, or whether more solid foundations may be warranted to support the work of the CEBS and the other Level 3 committees. Ideas for strengthening cross-border cooperation among supervisors, for example by including a specific EU-related reference in the mission statements of national supervisors and/or by allowing qualified majority voting for decision-taking in the Level 3 committees, are already on the table. It is certainly useful to analyse such proposals in more detail, with a view to identifying potential benefits and other implications.

Second, I would argue in general that the outcome of the efforts towards supervisory convergence will also be influenced by **the degree of involvement of supervisors in the design of financial regulation at the EU level**. Experience with the Lamfalussy approach in the field of securities tells us that, if the Level 3 committee – in that specific case the Committee of European Securities Regulators (CESR) – is strongly involved in providing advice on the draft Level 2 legislation, the subsequent work on supervisory convergence and co-operation by the committee concerned is made easier since it is based on a common understanding among the competent supervisors of the scope and content of the relevant provisions. As we know, in banking CEBS' involvement in providing advice on draft Level 2 legislation is limited, due to the structure of the Level 1 legislation which combines both general principles and technical provisions. Therefore consideration could be given to extending the role of the CEBS in this respect, also to give additional impetus to the pursuit of supervisory convergence. Enhanced involvement of the CEBS in an advisory role in draft Level 2 legislation could also be combined with an intensified role in removing the so-called "goldplating", namely the layers of national legislation extending beyond the EU rules, as well as the numerous options for supervisors provided by the current framework. In this way, a more homogeneous regulatory framework across countries would be promoted.

Third, the success of current efforts to enhance cross-border supervision will also depend on supervisors making the best possible efforts to ensure consistency and reduce complexity in practice. To that end, an **effective application of the principle of proportionality** in supervisory cooperation could be an important factor. While it is clear that effective and efficient supervision at group-wide level will eventually require that all competent supervisors move in step, a more prominent role for the supervisors of the most significant group entities, in line with the well-established supervisory principle of proportionality, could facilitate the development of common supervisory approaches and cooperation procedures. An effective application of the proportionality principle could also help to reduce potential incentive problems already at an early stage by structuring supervisory relationships in line with the relative importance of individual group entities for the group as a whole and the host countries concerned, before entering into substantive discussions regarding best supervisory practices and cooperation procedures.

To illustrate this point, and looking only at the distribution of assets, let us assume that a possible threshold of at least 5% of either group assets or domestic banking assets represents a rough criterion for identifying significant group entities. If we were to apply this criterion to the key cross-border players, there would be on average three countries in which significant group entities were located. This would be a significant reduction from the current average of 12 countries in which the banking groups operate. This example is purely indicative of the possible positive effects of applying in full the principle of proportionality in the pursuit of supervisory convergence while respecting the current institutional framework. In practice, we all know that the identification of significant group entities is not always straightforward, but requires a comprehensive, case-by-case, assessment of various factors, relating especially to the internal structure of the group and the distribution of group assets across countries, as highlighted also in the CEBS home-host guidelines.

Another important factor in further streamlining the supervisory interface for cross-border entities and economising on supervisory resources could be a greater recourse to the **cross-border delegation of tasks**, and where appropriate, responsibilities. I look forward to the results of the work that the CEBS is conducting in this area, in line with the recommendations of the FSC report on financial supervision which was endorsed by the ECOFIN Council on 5 May 2006.

Finally, the success of the efforts to develop a consistent supervisory framework will depend also on an **active and effective role of market participants**. While supervisors should stand ready to deploy adequate resources and make adjustments to national approaches to enhance supervisory convergence and cooperation, initiative and commitment on the part of the banking groups themselves is indispensable for making progress in the future. I would just recall in this context as an example that adequate group-wide tools and procedures for risk management and the effective dissemination of relevant information within a group are basic prerequisites for streamlined supervisory action. The experience of the CEBS Consultative Panel and public consultations characterised by an active involvement of market participants indicates that there is a strong will on the part of the industry to contribute to the success of the supervisory efforts.

Conclusions

Let me briefly conclude. The CEBS has made significant progress so far and this has been acknowledged and appreciated by all interested parties, including the ECB and the Eurosystem.

The work of the CEBS has laid the foundation for a supervisory framework in the EU which should be able to promote on the one hand further banking and financial integration and at the same time maintain its effectiveness in pursuing financial stability in a more integrated financial system.

The full success of the framework established by the CEBS should not be taken for granted. It will depend on the continuous improvement of several factors including further possible progress in the decision-making process of the CEBS, a sustained high degree of commitment on the part its members and the necessary constructive role of market participants.

Thank you very much for your attention.