Mr. Meister reviews the response of bank supervisors to the growing competition within EMU Lecture delivered by Mr. Edgar Meister, a member of the Board of the Deutsche Bundesbank, at the Bank of Greece in Athens on 12/10/98.

I

"panta rhei", "all is flux"

Ladies and gentlemen, these words, attributed to Heraclit, readily cross one's mind on the eve of EMU, both with respect to the previous course of events in the European integration process and with respect to the events still lying ahead. As so often in the past, politicians and businessmen must adjust to legal and structural changes, which on this occasion have been triggered by the forthcoming European Monetary Union. Germany joins EMU next year, and Greece will follow as soon as possible (that is likely to be in the year 2001). (Greece has already immortalised itself on the Euro banknote). In the field of banking supervision, Greece will from the outset be a genuine "in" country, or actually is one already: the European harmonisation of banking law encompasses all EU-countries. In the Banking Supervision Committee of the ECB, "ins" and "pre-ins" as a rule are sitting round the same table, with equal rights. And such co-operation round a single table will be necessary once those responsible are required to decide on supervisory responses to the growing competition within EMU.

II

After all, it is to be expected that competition within the banking sector in "euroland" will intensify. In the first place, the euro will act as a catalyst of trends that are leading to a globalisation of financial transactions world-wide and going hand in hand with this to fiercer competition among banks. The deregulation and internationalisation of banking business are topical buzzwords in this context. Secondly, the introduction of the euro itself will reinforce competition: the disappearance of exchange risk and transaction costs in the future euro area will result in a high degree of market integration, especially in the financial sphere. That is likely to culminate in increased interbank competition, due both to changed behaviour on the part of bank customers and changed behaviour on the part of the banks themselves.

Already from the start of 1999 the Euro is going to be introduced in form of deposits and prepaid cards. Thereby the capacity of bank customers to compare rates and charges across borders, without the need to worry about exchange risks will grow. This, should enhance competition among individual products. It is also likely that multinational firms will seek to consolidate Treasury operations, which were previously spread over many currency zones. Hence competition for customer relationships might increase, too.

The single currency will also change the behaviour of financial institutions, prompting them to think about the competitiveness of European and not just national markets. In areas near national borders, small institutions, hitherto operating only locally or regionally, will be able to operate in markets that have not been accessible to them in the past, but at the same time they will likewise be affected by the keener competition.

However, banks will not only have to face growing interbank competition: as the euro will probably foster the growth of a much larger and more liquid securities market in Europe, securities markets may be expected to pose a significant competitive challenge to banks offering traditional forms of intermediated credit.

Banks should prepare themselves thoroughly to face all these challenges. For only well-prepared banks will be able to open up new markets in „euroland", while ill-prepared banks will be at risk of losing existing market shares on account of the intensification of competition.

III

How is this growing competition to be rated in prudential terms?

In line with the regulatory policy decision in favour of a market economy system, in the EU-countries the necessity of competition as a guarantor of the viability of the market is being endorsed in the banking sector, too. Moreover, the beneficial effects of competition for consumers - in the form of enhanced efficiency, innovation, a broader range of products and cost cuts - are undisputed. Even so, it cannot be denied that the repercussions of the increasing competition pose additional challenges for banking supervisors.

One such repercussion is the process of concentration which already takes place in many countries' banking industries in the form of mergers. That process will result not only in fewer and larger banks in continental Europe, which is already felt to be "overbanked", but also, no doubt, in radical structural changes.

Mergers may constitute a reasonable adjustment, in terms of both size and strategy, to an enlarged market in the context of EMU, and may help to improve banks' viability. The wave of mergers currently in progress in Germany hardly rates as a cause for concern in prudential terms. Mergers for the purpose of enhancing efficiency are likewise to be expected among Greek banks. In addition, the sale of government interests in a number of banks will change the banking sector in this country.

Quite generally, however, the fact of the matter is that size alone by no means implies a hallmark of quality. The hoped-for commercial advantages of such mergers must materialise first. In terms of banking supervision, "mega- mergers" involve the drawback that banking structures become less transparent and groups become more difficult to control by the management. Overall, the number of institutions that are to be classified as "too big to fail" will increase.

In the context of the growing competition, there is also a danger that banks will run greater risks in order to defend their market positions and make attractive profits. That may lead to a tendency towards increasing fragility and a higher probability of market exits, which would make additional demands on banking supervisors. Furthermore, the current problems of the hedge fund LTCM show that the danger of excessive risk taking is not limited to banks. Against this background the precise measurement and monitoring of risks, sufficient transparency, a strong capital base and an adequate supervision become factors of increasing significance. This does not only apply to supervised banks but principally to other major players on the financial markets.

With regard to hedge funds my preliminary conclusions are threefold:

1. Bank loans to hedge funds should be limited in relation to the funds' own capital to contain their leverage and thus excessive risk taking (for example ratio of own capital to loans 1:10)
2. Hedge funds' exposures should be made transparent through for example an international credit and derivatives register. And
3. Banks should basically not be allowed to invest in hedge funds.

Coming back to my main topic, competition in EMU: In particular, the following points will be of paramount importance to banking supervisors, to enable them to adjust to the growing competition within EMU and cope with its consequences.

- The continuation and deepening of the harmonisation of European banking legislation and of the pan-European co-operation among banking supervisors;
- the exploitation of competition to strengthen the market players' sense of responsibility and self-discipline;
- the creation of adequate transparency for both market players and supervisors;
- the further development of the capital provisions, as the keystone of banking supervision.

Allow me to elaborate on these points in greater detail:

IV

In view of the progressive integration of European financial markets accompanying EMU, there is a greater need for co-ordination between the European supervisory authorities and a need to press on with the process of the European harmonisation of banking legislation, which has already made considerable headway. In particular the Banking Supervision Committee set up at the newly established European Central Bank is taking due account of the greater necessity for co-ordination at the European level. Notwithstanding this strengthened co-operation, banking supervision in the European Monetary Union will remain a national responsibility. That is in line with the principle of subsidiarity and takes due account of the greater effectivity of close-at-hand supervision that is able to respond rapidly to regional special developments. Regarding the advantages of a close-at-hand supervision I can not see any current need for a centralised supervisory authority neither on the European level nor as a „super agency" or „umbrella supervisor" on the international level.

Co-ordination in the field of supervision has to be accompanied by harmonisation in the field of supervisory legislation. Besides risk considerations, competitive factors argue in favour of harmonised provisions in the single European market for financial services. The objective must be to ensure a level playing field, and to prevent national supervisory regulations from being misused as instruments of competition policy by proven standards being relaxed solely in order to make one's own financial centre more attractive. In this context one has to discuss as well, if and to what extent there is a need to extend international supervisory standards into offshore centers in order to make sure that financial players do not try to shift their business to such places with the aim of evading regulatory demands.

National central banks, which either play an integral part in banking supervision (as in Germany) or actually have the primary responsibility for all aspects of banking supervision (as in Greece), are of outstanding importance in the field of banking supervision in EMU. A weighty argument in favour of the participation of central banks in banking supervision is, in particular, their great proximity to the market , which they gain from their own participation in financial market operations as part of their lending business and through their performance of fiscal agent functions. This enables a central bank to advocate market-promoting deregulation measures, which are at the same time acceptable in prudential terms. Furthermore, there are many points of contact/interactions between the duties of a central bank and those of banking supervisors.

V

Within EMU it will be essential for banking supervisors, on the one hand, to exploit the disciplining effect of fiercer competition by means of suitable approaches to regulation in order to strengthen the sense of responsibility of market players. On the other hand supervisors have to prevent excessive risk-taking on the part of particular institutions. The construction of efficient risk-monitoring and risk-management systems in the banks is of paramount importance in this connection. Recent turmoils caused by banks' involvement in risky investments of hedge funds show that the necessity to further strengthen the risk management of financial institutions is high on the agenda. In this context, supervision performs an initiator function by prescribing certain standards which improve market discipline and the sense of responsibility. In Germany, for instance, appropriate minimum standards for the merchandise trading of banks were laid down in a publication by the Federal Banking Supervisory Office. Conversely, banks sometimes take the initiative themselves, as was found when risk-management models for gauging market-price risks were being developed. In that case, supervisors have to ensure quality control by linking market standards with conditions of their own.

This strengthening of market players' sense of responsibility and self-discipline acknowledges the market's role as a "complementary banking supervisor" which supplements traditional supervision in a useful manner. Global players are of outstanding importance in this context. With regard to their influence on the stability of the financial markets they should be well aware of their systemic responsibility.

In view of the current crisis in the financial markets of several countries the international debate on the extent to which traditional banking supervision can be replaced by a model of much more self-regulation by market participants has lost some of its original attractiveness. It is precisely in the area of systemic risk that the gravest weakness of self-regulation proposals lies: they generally ignore the connection between the right to lay down risk containment standards and the responsibility for preventing systemic risks. Thus, a shifting to the institutions themselves of the authority to lay down the law is called for without this being accompanied to the same extent by a shifting to the private sector of the responsibility for coping with systemic risks.

But, in my opinion, stronger self-regulation would entail the assumption of the responsibility for avoiding systemic risks and therefore the establishment of extensive safety nets by banks for coping with problem cases on their own responsibility. The safeguarding package quickly set up by international investment banks for the American hedge fund LTCM last month is a positive step in this regard. Hopefully it can also be seen as a sign of a growing readiness of banks to create a liquidity-safeguarding fund on a permanent basis.

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However, mitigating systemic risks would be better than transferring them to a newly created fund. Increased transparency could make a major contribution to that. After all, greater transparency enhances market discipline and is a precondition for the establishment of early warning systems for credit institutions, markets and supervisors. The Basle Committee has initiated important provisions for improving transparency at the international level. Key-words in this context are the improved disclosure requirements for derivative transactions and the recommendations on appropriate public reporting of merchandise transactions. As mentioned before the need of greater transparency is not limited to banks' information policy. The business of other market players, and their role in different markets, must become really transparent, too.

At the European level, the main issue in the next few years will be meeting the growing needs of banking supervisors and credit institutions for information on the borrowers of banks in other European countries. It will be necessary to further step up the co-operation that has prevailed for a number of years between the credit registers already existing in the EU (in Austria, Belgium, France, Germany, Italy, Portugal and Spain), and to foster the construction of such systems for reporting cross border loans in other EU countries. As part of such European co-operation between credit registers, it is intended to make that information, which has hitherto been exchanged only for prudential purposes, accessible to the lending banks as well in future. In my opinion the need for a central credit register is not limited to the European level. An international credit register and the publication of aggregated figures could play an important role in making existing risks in the global financial markets more transparent.

VII

In EMU, too, capital standards as a protection against loss will remain the cornerstone of banking supervisory provisions. An adequate capital base both in terms of quantity <u>and</u> quality stabilises not only the institutions themselves but also the banking system as a whole.

In this context, the Capital Adequacy Directive lays down an EU-wide foundation, which relates to market risks. In the course of the further development of the Directive, banks were given the option, as an alternative to the prescribed standard procedure for computing the required capital backing of market-price risks, of using their own risk-management models, subject to certain conditions. By thus modifying their instruments, European banking supervisors have responded swiftly to the changes in the markets, and have shown themselves to be consistent with market economy principles and close to the market as well. In addition, this new quality of supervision is geared more closely to individual business practices and a bank's risk situation.

The European capital provisions are based on the Basle capital standards adopted in 1988. Of late, increasing criticism has been levelled at those standards. They are accused, in particular, of providing for an overly imprecise and schematic measurement of hazards in the field of credit risks and of failing to take account of up-to-date hedging techniques. To some extent this criticism is generally shared. However, a model based approach has not always given the banks the safety level which they might have expected. The recently experienced losses of banks demonstrate what should have been already known that risk models are not an instrument to predict <u>future</u> developments.

Regarding the Basle capital provisions in general, which meanwhile constitute a standard that is accepted world-wide, they are adaptable enough for more recent developments in the markets to be integrated in that approach. That also goes for the topics under consideration at present, such as on-balance-sheet netting, credit derivatives and new capital elements. The dispute whether the standards should be developed further or whether a complete break with their approach is necessary in part seems to me a semantic problem rather than a material controversy. Where does modernising end and where would redesigning start exactly?

Hitherto, some major risks - notably operational risks and legal risks - have not been measured and are therefore not included in the Basle standards. But they should likewise be covered implicitly by the capital currently required. Hence, if it is decided to leave risk measurement to the banks, as a basis for the computation of the necessary capital base in the case of the credit risks as well, it must be assured that all the other risks faced by a bank are taken into account in a suitable form, too. For, given the rising trend of risks, more precise risk measurement by the banks must not result in a decline in the capital base. This applies to the amount of capital required as well as to its qualitative features. With respect to both aspects capital standards should not be designed in such a loose way that even countries with crises in their banking systems could meet the requirements. Special situations require special measures and possibly exceptions of the rules. However, the standard as such should be kept high enough to ensure credibility in the banking systems and the role supervisors play.

Regarding global players, who have a special responsibility for the stability of the financial system, even an increase of their capital base might be appropriate to take into account their systemic importance.

VIII

“panta rhei”, “all is flux”.

That is equally true of the development of the European financial sector, and the associated further course of banking supervision. I shall assume for a moment that Heraclit would have endorsed a “flux”, i.e. an evolutionary development of banking supervision, rather than an abrupt change of system.

Despite the recent turmoils in the financial markets the obvious readiness of private market players, supervisors, International Financial Institutions and politics to co-operate and to contribute to the stability of the financial system forms a valuable basis in order to handle the challenges lying ahead successfully.