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Convergence and supervisory practices in Europe: state of play and expectations

During the recent celebration of the 50th birthday of the Treaty of Rome, done under the aegis of the German Presidency, European global achievements since 1957 were highlighted so as to make all of us aware that working together yields significant benefits. In the banking sector, which is an important part of the internal market, one of those achievements, the European "history" started much later but it developed at an intensive pace, corresponding to the banking market integration but also under the pressure of new important challenges such as the setting up of the new prudential framework Basel II. The creation of the Committee of European Banking Supervisors – Cebs –, which took place in that evolutionary context at the beginning of 2004, led the supervisors all EU countries to work together, more than they ever did before.

This was necessary for many reasons. First, due to a growing number of cross-border players in the EU landscape, continuing to work on a pure national basis became a non-sense in terms of efficiency. Second, it appeared more and more needed that, for the sake of a level playing field, supervisors endeavour to apply in harmonized fashion the EU legislation. Third, the increasingly tougher global competition required that all efforts be undertaken to underpin Europe's financial position in the world, and a more efficient supervision at EU level could contribute to this objective.

Fostering convergence of practices as a core objective

In a nutshell, Cebs was requested to deliver, amongst others, convergence of practices. So far, did it enough in that direction? That is not an easy question as the answer would probably differ depending who voices it: the Cebs is moving fast, but so does the industry, and a gap could appear if the paces were too different. As chair of Cebs, I would not try to propose an answer as, anyway "one can not be judge and judged"; but at least could I shed light on the main achievements of that committee so far, in a context where the expectations as to what it should effectively deliver have never been so high.

Cebs was set up as part of the Lamfalussy approach to financial regulation in the EU – so named in reason of the key role played by Baron Alexandre Lamfalussy in the process which gave rise to the final report of the Committee of Wise Men on the regulation of European securities markets. This report proposed a four-level regulatory approach which is designed to make the decision-making procedures faster and more flexible, while still ensuring the uniform application of community law. New powers were given to supervisory committees known as "Level 3" committees, like Cebs. They are expected to deliver convergence in supervisory practices and to contribute to a level playing field across Europe.

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Seit der Gründung des Committee of European Banking Supervisors (Cebs) im Jahr 2004, so die Autorin in ihrem Lagebericht, hat sich die Zusammenarbeit der nationalen Aufsichtsorgane in Europa wesentlich verbessert. Hinsichtlich des Hauptziels des Komitees, die Umsetzung der Capital Requirements Directive als Manifestierung von Basel II auf europäischer Ebene im Detail zu begleiten, sieht sie die Implementierungsphase erreicht. Eine Schlüsselrolle misst sie dabei der Konvergenz der Aufsichtspraktiken im Tagesgeschäft zu. Um diese zu fördern, so hebt sie hervor, wurde unlängst ein Verfahren zur Mediation zwischen den beteiligten Parteien vorgelegt. Für die Zukunft hält sie aufgrund der dynamischen Entwicklung und sich bildender Konglomerate auch über die sektoralen Grenzen hinaus eine Zusammenarbeit der Ausschüsse im Banken- und Versicherungsbereich für notwendig. (Red.)

National consistency

Starting operations in January 2004, the Committee was mandated with three main tasks: first, to provide advice to the European Commission; second, to ensure consistent implementation of community legislation in the banking field and convergence in supervisory practices; and third, to promote supervisory co-operation and exchange of information. These three tasks mirror those set for the other two Lamfalussy sister committees; the Committee of European Securities Regulators (Cesr) and the Committee of European Insurance and Occupational Pensions Supervisors (Ceiops). From an organisational perspective, the new framework is often compared as a "hub and spoke", in which Cebs would form the former and the national authorities the latter; this means that while each authority remains responsible for the supervision of the institutions located in its jurisdiction, there is, at European level, enhanced cooperation aimed at making the national processes more consistent and convergent.

As the European legislators who set it up wanted to be certain that the whole Lamfalussy process delivered what they expected it to, they decided that is should be assessed in 2007. The process, which is undergone in a step by step approach, has started in 2006 under the aegis of the Inter-institutional Monitoring Group – IIMG –, which comprises six independent experts – and should be completed end 2007.

A structuring workstream for Cebs

This new organisation for European banking supervision took place while European legislators were finalizing the discussions on the Capital Requirements Directive – CRD –, which was finally jointly adopted by the Parliament and the Council in June 2004 and has come into force since the beginning of this year. The CRD, which transposes the Basel II framework into EU legislation, represents a fundamental shift in banking supervision. Beyond harmonising capital requirements, it encourages financial agent to improve their risk management processes and leads banking authorities to move from a rule-based supervision to a risks-based approach.

Not only were European supervisors given the opportunity to prepare the implementation of a fundamentally new regulatory framework but they had to do so within a completely new institutional environment. Hence, two challenges generated the bulk of the Cebs activities and deliverables since its creation, and, all in all, represented its overarching objectives: to contribute first to European financial stability in an efficient fashion by striving towards a harmonised and enhanced banking supervision within the internal market; second, to the competitiveness of European banks vis-à-vis third countries ones. But what happened on the ground, in terms of convergence and cooperation?

A framework for convergent implementation

Over the past three years, Cebs has developed a wide range of tools to foster convergence and strengthen cooperation. In fact, after devoting most of its efforts to deliver guidelines, before the CRD came into force, the Committee now focuses on concrete issues related to the implementation of the latter; this represents the shift from "design to delivery".

As regards to the first phase – delivering guidelines –, two aspects have to be highlighted. First, the relevance of the guidelines with regard to the need to ensure a smooth and convergent implementation at European level. Second, the way the guidelines have been elaborated. Considering the relevance, Cebs has tried to cover all the parts of the CRD that needed more guidance before implementation by both banks and supervisors, in order to achieve properly the objective of convergence. In that respect, core aspects of the European directive have been subject to Cebs guidance. If we look at the most emblematic changes introduced by Basel II, we should mention here internal models within Pillar 1, supervisory review process under Pillar 2 and transparency in the framework of Pillar 3:

– under Basel II, banks have the choice between different approaches for the management of risks, from simplistic – and not much risks-sensitive – ones to more complex and more risks-sensitive ones. Within these latter, if their supervisors have given them the authorisation to do so, banks use their own estimates of risk parameters to determine the capital requirements. The approval process – which includes to the different tasks undertaken by supervisors to assess the accuracy of data, the robustness and reliability of internal systems – is then key and explains why Cebs has started working on a specific guidelines just after it was set up, sufficiently early to help supervisors and banks effectively use it;

– another key concept of Basel II is the Pillar 2, which is related to the structured dialogue that must take place between supervisors and banks as to the assessment, beyond Pillar I, of the soundness of the risk management and of internal capital ; here again, this piece of work was deemed of utmost importance by Cebs, which delivered complementary guidance in this regard, well ahead of the CRD coming into force;

– as to transparency and market discipline promoted through Pillar 3, Cebs has considered it critical to help market participants compare supervisory rules and practices developed across the EU for the implementation of Basel II. To that end, a detailed framework has been set up, to be filled in by each national authority. This process, the so-called Supervisory disclosure, is intended to have powerful positive effect on convergence. In that regard, it is worthwhile mentioning that, in the second interim report of IIMG (published at the end of January), it is considered as a useful tool which could be expanded to other sectors than the banking one.

Still room to grow

Beyond these examples, other guidelines should be mentioned, two of which are related to reporting (prudential and financial). Considerable efforts have been devoted by supervisory to develop a common framework for reporting purposes. While high expectation from the industry could lead at first sight to the conclusion that the remaining distance between the current achievement and the final objective is important, which Cebs is well aware of, it should also be noted that the Committee started from scratch in this area. The current stage should not be viewed as the end of the story: Cebs if fully committed to continue its efforts to alleviate reporting burden for industry.

As to the guidelines related to home-host cooperation, the latter is currently subject to a "reality check" with the emergence of concrete issues which, to be solved, need the setting up of operational arrangements; this point is developed hereafter.

Concerning the way these guidelines have been elaborated, this leads to digging into the consultative process vis-à-vis the industry. An enhanced and structured dialogue with market participants has been deeply enrooted in Cebs' working method since its creation. Each guideline gave rise to extended consultation with the aim of making it as much adapted as possible to market diversity. True, not all the comments voiced by the industry were taken into account but the Committee carried out the process in a fully transparent fashion, explaining why it was not deemed appropriate to take one proposal one board.

This interaction between industry and Cebs during the phase of conception has been key to ensure the effectiveness of the guidelines after implementation. Fully in line with the Lamfalussy philosophy, such a process is key to help us better understand industry practices and reach a common stance toward them. Regulation and level 3 guidances can not live in isolation from markets developments and need sound technical input, in order to promote sound risk management which contribute to achieving financial stability.

Effective convergence of practices

During this first phase, Cebs designed the general framework within which it intended to operate in the implementation period. The environment for convergent implementation of Basel II has thus been set up. But as CRD progressively comes to life, there is a growing need for Cebs to make sure that its guidelines effectively deliver convergence in day-to-day supervision. To this end, the Committee set up, mid-2006, on a test basis for a sample of ten major cross-border groups, new arrangements for operational networking, designed to overcome the practical issues of cross-border supervision under Basel II.

Building on the guidelines related to the cooperation between consolidating and hosts supervisors, these arrangements are intended to work as a bottom-up mechanism for addressing issues emerging in the day-to-day implementation of the Capital Requirements Directive and Cebs' guidelines. Within this framework, line-supervisors of the ten groups are working at identifying pragmatic solutions and areas for further technical work.

This is now working at full speed in the form of college of supervisors, with focus currently laid down on validation issues. It encouraged supervisors to work together in a cross-border context in a way that helps them fulfil their prudential objectives in a more efficient fashion. Admittedly, this has not solved, so far, all the problems that have arisen from the approval process for internal models. However, it must be perceived as a gradual approach towards more convergence, as the latter is subordinated to a common precise understanding of the issues, which in turn depends greatly on the depth of prior exchanges of technical information and views.

These arrangements reflect more generally Cebs' commitment to carry out its tasks by adapting itself to its environment and to market practices. In this respect, seminars on specific issues have been organised with the industry, and this process, which has proved to be efficient, should be renewed in the future. Recently, a fruitful discussion was organised on proportionality, a concept that transcends many aspects of the Committee's tasks. A common understanding of the concrete issues at stake was reached, preparing the ground for efficient implementation of the CRD and guidelines, especially for small banks.

Besides these operational arrangements, Cebs has been requested by Ministries of Finance, following the so-called Francq report on financial supervision, to develop specific tools aimed at fostering convergence. In particular, the Committee has prepared, usefully inspired by what Cesr did in that regard, a framework for a mediation mechanism, which has just given rise to the publication of a consultative paper. While the use of this mechanism by national authorities is expected to be very exceptional, since enhanced cooperation is designed to address at an early stage issues emerging between them in the context of the supervision of cross-border groups, its setting up must be considered as a complementary means to achieve the objective of convergence.

Cebs also further explored the concrete means to develop a common "supervisory culture" amongst its members, through increased staff exchange and common training. In addition, the Committee has decided to implement progressively a peer review process, which will constitute a powerful tool towards further harmonisation in the implementation of the CRD.

The cross-sectoral dimension is developing

Convergence and cooperation are not a matter for Cebs only. Reflecting the increasing interactions between banking, insurance and securities markets, the cross-sectoral issues to be dealt by supervisors are continuously growing. So does the cooperation of Cebs with its sister committees, which results in important pieces of work about issues with a significant cross-sectoral impact. This is the case for the supervision of conglomerates, for which Cebs and its sister committee for insurances, Ceiops, regularly meet, in the framework of the Interim Working Committee on Financial Conglomerates – IWCFC – to analysis issues of potential divergence and find out the best way forward to tackle them.

And everyone has in mind that the Solvency II project for insurance companies, the "sister" reform of Basel II aimed at modernizing the prudential framework for the latter, forms the ground for further convergence.

Next steps?

Cebs' main projects since 2004 were to finalize common guidelines towards convergence and timely implementation of the CRD. At present, its priority are to effectively implement them and, in this regard, emphasis should be laid on operational networks. It has also adopted – or will shortly adopt – appropriate mechanisms to deliver concrete progress in this area, such as mediation. But the convergence of practices is definitely a dynamic process: what has been done so far, thanks to a non complacent and high quality dialogue with all stakeholders and the strong commitment of Cebs' members to move forward, clearly paves the way for further achievements.