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Notes on the **convergence** of banking supervision practices in Europe

Over the past ten years, the EU single financial market has taken crucial steps towards the creation of progressively more interrelated and integrated financial markets. These developments have been possible not only as a result of close co-operation between governments, but also due to the strenuous efforts of market participants and European institutions and the co-ordination and close cooperation of monetary and supervisory authorities.

European citizens also deserve a special mention, as they have faced up to these changes, and to the costs of adapting to the new environment, in an open-minded way and with a pro-active attitude. In sum, all the interested parties have made a great effort in this common project, making concessions in the short term in order to pursue general interests which in the medium and long term will provide significant net advantages, some of which we are already enjoying.

Diminishing volatility in financial markets

At the same time, many factors have contributed to a diminishing volatility in financial markets and to increase the degree of liquidity, against a framework of low interest rates. Among these factors the following can be cited:

– the progressive interrelation between markets and across countries,

– the proliferation of new markets and intermediaries,

– the easy redistribution of risk across markets and agents due to developments in credit risk transfer markets with a high degree of liquidity where risk protection can be sold and bought,

– the creation of new products which have eased access to finance for many agents with previous problems, for example, to purchase a house or to renegotiate debt, or

– arbitrage between markets, which has helped to lower spreads.

To some extent, not only have all these factors made the European financial system more efficient and resilient, but they have also contributed to lubricating macroeconomic mechanisms. As could not be otherwise, European supervisors and regulators have also made an effort to adapt to the new environment and to cast a cautious eye over markets, particularly those which are not regulated and which exhibit an extremely low degree of standardisation and strong international interrelations.

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Mit IAS, Basel II oder auch der Ausweitung des Lamfalussy-Verfahrens auf Banken und Versicherungen, so konstatiert der Autor, wurden in Europa trotz ausgeprägter nationaler Strukturen bereits gute Fortschritte hin zu einem stabilen, einheitlichen Finanzmarkt gemacht – auch wenn dies aufgrund von Meinungsverschiedenheiten, gegenläufigen Interessenlagen und nicht zuletzt einer träge anmutenden europäischen Rechtssprechung an einigen Stellen zu Verzögerungen und Widersprüchen führte. Gleichzeitig warnt er davor, nun die Hände in den Schoß zu legen und etwa den „Schwebezustand" bei Kreditderivaten zu ignorieren, wo die Umverteilung der Risiken nur schwer überschaubar sei. Um eine echte Integration zu erreichen, hält er insgesamt ein EU-weites Aufsichtssystem für unausweichlich. Dieses müsse dabei nicht aus einer zentralen Kontrollinstanz bestehen, sondern vielmehr über angemessene Strukturen für die Beaufsichtigung international agierender wie auch national tätiger Institute verfügen. (Red.)

Encouraging harmonisation: IAS, Basel II

And, of course, the European process of financial integration has not been insulated from the wider globalization of financial markets and operations. Indeed, these developments have represented simultaneously a challenge and an incentive to encourage and accelerate the process of harmonisation.

Among other examples, the adaptation of the new accounting rules IAS (International Accounting Standards), and their transposition into national laws, should be highlighted. The new accounting framework is based on principles and guidelines rather than on rules, as demanded by more sophisticated and innovative markets. Although the implementation of the new rules is still an ongoing progress in some countries, it seems to be proceeding in a satisfactory manner, especially when one considers the profound changes in the accounting orientation that they imply.

The new international capital framework, known as Basel II, is also rooted in the same approach. This new orientation has reinforced the key role of the internal risk management systems of financial institutions, with a significant impact not only on financial institutions but also on supervisors, implying a significant change in the supervisory approach. These changes are being implemented satisfactorily against a framework of active and orderly discussion as corresponds to their magnitude and importance.

The successes reflected in the opening paragraphs should not be taken to mean that the creation of an integrated financial area is an easy task, nor that the process is complete. Indeed, the EU financial sector is still characterised in some important areas by the peculiarities and idiosyncrasies of national regulations, codes of conduct and, on many occasions, locally different customer practices. These are the result of different historical experiences and many of them are rather deep-rooted.

And, although the efforts hitherto have led to significant and visible results, even perhaps more than might have been expected in the earlier stages by ourselves inside the EU or by others outside, the process has sometimes been subject to delays and contradictions, as a result of difficult negotiations between countries with different views or experiences or because of the complexity and slowness of the European legislative machinery. But these drawbacks have been continuously monitored and efforts have been made to overcome them.

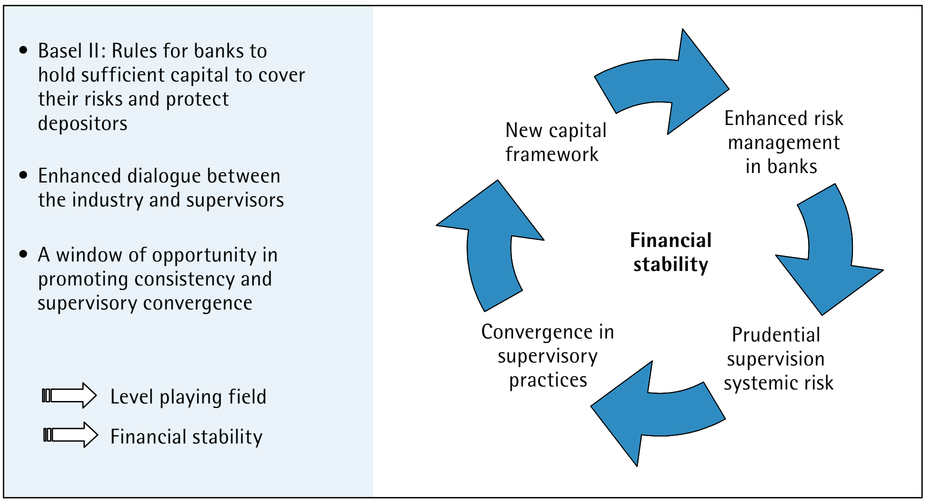
Extending the Lamfalussy approach

A clear example of this was the report of the Committee of Wise Men under the chairmanship of Alexander Lamfalussy in 2001. This report was commissioned by EU finance ministers, who were concerned that the integration process needed to be speeded up in the securities markets sector. The Financial Services Action Plan (FSAP) of the Commission had proposed a series of legislative measures, but the legislative machinery was too slow to accommodate them. The Lamfalussy report proposed a structure to make the regulatory process more effective, faster and more flexible.

The Ecofin Council agreed in December 2002 to extend the Lamfalussy approach to the banking and insurance sectors. As part of the new structure, the Committee of European Banking Supervisors (Cebs) was created in January 2004. Cebs brings together supervisory authorities and central banks of the 27 EU countries as well as the European Central Bank. It is charged with promoting convergence of supervisory practices, especially in the implementation of the European legislation, with advising the European Commission on banking issues and supporting the exchange of information between supervisors. And Cebs also works together with its sister committees in the securities and insurance sectors (Cesr and Ceiops) to promote cross-sectoral cooperation.

But Cebs is not the only committee of banking supervisors in the EU. In addition, the Banking Supervision Committee of the ECB, until now under the capable chairmanship of Edgar Meister of the German Bundesbank, has focused its activity on the analysis of macroprudential issues with financial stability implications and on providing advice to the ECB regarding the im-

Figure 1: Basel II and financial stability



pact of regulatory questions on the financial system. For example, part of the BSC's recent work has related to developments in credit derivatives markets, hedge funds, private equity and their implications for financial stability. From this perspective, the BSC collaborates in specific projects with the Committees of the 3L3. In addition, the BSC carries out an important work of analysis regarding the collection of information and data in areas were information provided by financial intermediaries or markets are currently almost non-existing (among others: credit derivatives, relation of banks with hedge funds, involvement in leveraged buy-outs, risks of counterparty in the credit derivatives markets).

Providing recommendations and guidelines

As mentioned in the previous section, the new international accounting rules and Basel II are rooted in the proper working of internal risk control systems in financial intermediaries. The intention is not for supervisors to monitor intermediaries through the application of a long and detailed set of rules. Rather, their role is to provide a set of recommendations, guidelines and capital requirements which internal risk systems should comply with.

Basel II in particular provides an excellent example of this new approach. Not only does the new framework capture and recognise the best risk management practices of the leading banks but it also provides a set of incentives to raise the standards across the industry generally. The combination of adequate capital, improvements in risk management practices, a risk-focused approach to supervision and increased dialogue both with individual institutions and the industry in general, and greater convergence of supervisory practices across borders creates a "virtuous circle", which in turn should promote greater financial stability.

Facing the future: the challenges ahead

Returning to earlier comments, it is clear that significant progress has been made in integration and that the European financial framework is much more developed than in the early stages of the EU. The roots appear to be well-established, as has been displayed in the face of the financial disturbances recently suffered by markets. However, as experience teaches us, complacency can lead to excessive optimism. A financial disturbance could become a systemic financial shock with serious repercussions on the whole system. This is particularly true in a world which is increasingly interrelated and where investor sentiment can be very sensitive to any local disturbance.

It cannot be ignored that the buoyant activity in international credit derivatives markets with progressively more sophisticated structured credit products, with a low or even null level of standardisation of contracts, and where redistribution of risks is easy and rapid, makes the assessment of counterparty risks a highly complex task. In addition, in the current framework with important activity in credit risk transfer markets, the different types of risks would tend to blur in case of significant variations of asset prices (credit risk, counterparty and market risks). Internal risk control systems of financial intermediaries take these elements into account, mainly when applying techniques such as value-at-risk models or econometric models based on historic data which do not reflect the complexity of markets and the possible drastic change of correlation between assets and/or markets. Moreover, under stress conditions liquidity may be substantially reduced.

Promoting stress exercises

These reflections should not lead us to be pessimistic or reluctant to recognise the enormous advantages that recent developments have provided to our economies and our lives. However, it is the role of regulators/supervisors and also of the members of the industry to be conscious of events with low probability of occurrence but serious capacity of damage and to mitigate as far as possible such damage, for example promoting stress exercises under different scenarios. The role of supervisors is to monitor regulated entities and ensure that market discipline is properly working.

And it is clear that supervisors cannot simply focus their efforts within national borders. As has been noted above, cooperative efforts have increased and continue to increase with the internationalisation of markets. In the EU context, and given the objectives to achieve a fully integrated market in financial services, it seems likely that we will eventually need a EU system of supervision. This does not, however, mean a single EU supervisory authority, which would raise a whole range of complex policy and organisational issues. Rather, such a system should be based on the best international practices for the internationally active banking groups, while also taking into account the knowledge and expertise of national supervisors for more locally-based institutions.