Challenges for EU supervisory arrangements in an increasingly global financial environment

Allocution prononcée par

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« Challenges for EU supervisory arrangements in an increasingly global financial environment »

1. Financial institutions are becoming more and more international and their cross-border activities often represent the bulk of their revenues.

Moreover, the functioning of these institutions is more and more of a global nature : strategy and development, organisation along business lines, risk assessment, asset-liability management, funding needs, liquidity issues… are all increasingly dealt with at the worldwide group level.

This is the way most international financial institutions operate : on a global basis. This is the way they report to their shareholders and clients : on a consolidated basis. This is the way the Basle committee deals with capital adequacy issues : on a global basis.

2. From that starting point, in an ideal vision, these global financial groups should be regulated and supervised on a worldwide basis at group level in order to cover the entire range of their activities across all borders.

Of course, this cannot be carried out at the present stage for obvious political reasons. But at least, the European Union's objective should be to intensify their efforts to establish adequate cooperation agreements with third countries (through the negotiation of memorandums of understanding with mutual recognition of prudential supervision). This would ensure a level playing field between EU groups and their non-EU competitors.

3. While pursuing such an endeavor, there is an immediate task which must be carried out : to establish in the EU (which, after all, is ment to be a single market) a more effective supervisory system for european internationally oriented financial groups.

As has been said today by those who spoke from the standpoint of the industry, we live in a strange paradox : while global management, financial integration and cross-border operations are the forces at work, our regulatory and supervisory system is still largely national. Directives are too often "transposed" in national legislation with the addition of local specific options.

Groups are segmented, for the purpose of supervision, in national legal entities. The drawbacks of such fragmentation have been, to some extent, mitigated by valuable cooperative efforts in the framework of the Lamfalussy process.

But experience shows that, whatever the willingness and spirit of cooperation that has been displayed by regulators and supervisors, the system is far from being adequate. Too many different requirements in terms of reporting are one of the drawbacks observed. But, perhaps more importantly, a nationally conducted supervision of liquidity as well as of risk assessment models is meaningless : it has to be carried out a the group level. If that is not the case, costly and uneconomical duplications will arise.

This is a serious observation : too many diverse national supervisory requirements can be so cumbersome that they tend to delay and hamper the finalisation of internal risk modelling which is so important to carry out.

Let us not underestimate the danger of this fragmentation. Specific local reporting requirements from subsidiaries in host countries tend to become formal obligations which often ignore group based information that is necessary for the understanding of the real risks incurred by those subsidiaries.

This is certainly not a good setting to deal appropriately with crises situations if they were to arise.

The case of Solvency II is particularly relevant in this respect. A fragmented supervisory framework would deprive insurance companies from taking advantage -as they should- of geographic division of risks and of capital optimization. This would result in higher immobilised owned funds than necessary and in more expensive tariffs for clients.

4. So what should be done ?

I believe one should distinguish between the regulatory and the supervisory aspects of the issue.

a) on regulation, it is obvious that there is the need for some political push.

If there are differentiated transpositions it its because directives allow national habits and preferences to prevail.

One can address this problem in different ways :

- enshrining in the political ambition of the Union the notion that regulatory convergence is a basic objective of the EU and giving level 2 and 3 committees a “European mandate” ;
- providing adequate -and similar- powers to national regulators ;
- reducing to an absolute minimum the national discretionary options ;
- agreeing on a binding decision making process by deciding that after a certain number of years, these national options automatically disappear : they are there only for a transition period ;
- if that is not possible, let the cross-border groups opt out from national options ;

- not relying on level 3 to simplify and improve initial inadequate regulatory rules.

These measures would result in a true level playing field in the regulatory area.

b) on supervision, there are two possible approaches : one focused on continued cooperation, and one which would adopt the concept of a "lead supervisor" who would be the one of the home country and who would be responsible for the group at large (including subsidiaries in host countries).

I believe, personally, after having observed the excellent results but also the limits and delays involved in cooperation, that a form of "lead supervision" has now become indispensable, as members of the financial industry have been stressing in this conference.

This would answer, indeed, the fundamental dilemma that has been the underlying theme of today's discussion : " how can one supervise a "hub" by breaking it up into different national segments ?"

I know, of course, that there are objections and questions raised by this proposal of a "lead supervisor".

These objections must be taken care of. But some of them exist "in any case", be it in a national or a "lead supervisory" setting[1]. I am thinking for example, of the issue of how to deal with a "host located crisis" if a subsidiary of a large group were to fail. That issue is not necessarily better dealt with in a national setting because of the asymmetric information problems that I mentioned above. But it is also true that host countries need to be assured that the interested "lead supervised" group and its lead supervisor will not let down host subsidiaries and monopolize liquidity and capital for the sole help of the centre.

This means that confidence must prevail between the lead supervisor and the host authority.

The idea is to ensure that lead supervisors will act in a responsible way and not persist in the "bad habits" of national fragmentation, (if not we would have separate, vertical, specificities between the different lead supervisors). The best solution is to inject some form of collegiality in the way lead supervisors do their work as is already the case in the insurance business.

This can be achieved in different ways and I will not dwell on them in detail at this stage. Let me just suggest a pragmatic approach. Taking into account the geographic composition (and weights) of a pan european group, a board or a committee of supervisors could be regularly called upon by the lead supervisor in order to exchange views on a group's risk profile, the adequacy of its risk assessment systems, possible concerns on its strategy, the modalities of supporting host subsidiaries if needed…. This would naturally lead to a single reporting system. And also to a somewhat integrated control or inspection programme in which host supervisors would play a role.

In case of divergent views among supervisors, the lead supervisor would have the last word after a discussion period (as it has been decided in the CRD for the validation of risk models). This implies that the lead supervisor would be responsible vis à vis the different interested

[1] This is why we should not be waiting to solve all the problems related to a systemic banking crisis (burden sharing, safety nets, lender of last resort, single European bankruptcy procedures….) before we address the supervisory issue which is the most pressing one, given present competitive conditions.

national authorities and that the international financial institutions in questions -which would take advantage of own funds centralization- would also deal with their subsidiaries abroad as a “group issue”.

If these precautions and the adequate collegial inputs were to be adopted, several objectives could be reached :

- simplification of reporting requirements,
- recognition of the global nature of international groups,
- mechanisms to avoid the “orphan host” syndrome,
- gradual convergence of supervisory methods and processes (through board discussions).

I have already suggested that such ideas be studied by a group of financial institutions, regulators, supervisors, parliamentarians and the Commission, in order to achieve quick and practical results. Time has come for action.