SPEECH

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

DATE: May 13 2005
SPEAKER: First Deputy Governor Eva Srejber
LOCALITY: 33rd Economics Conference of the Oesterreichische Nationalbank
Vienna Marriott Hotel

■ The divorce between macro financial stability and micro supervisory responsibility: are we now in for a more stable life?

Introduction

I hope I won't disappoint our kind hosts who asked me to deliver this address but I have a confession to make – in Sweden, macro financial stability and supervision are not divorced. They have never been married. Indeed, it is only quite recently that the Riksbank and the FSA (Financial Supervisory Authority) have started to acknowledge – operationally in their respective policy frameworks – the link between macro financial stability and micro supervisory issues.

Whether we just got divorced or are soon to get married, the relationship between financial stability and supervision is highly relevant. I will structure this address in the following way. First, I will give a brief description of how the relationship between supervision and financial stability has developed in Sweden. Then, I will move on to the financial sector developments that now challenge the ways supervisors and central banks have been working. The process of internationalisation, in general, and cross-border integration, in the EU, will force both supervisors and national central banks to focus on their core tasks and to a certain degree invent new ways to perform those tasks. Finally, I will comment more specifically on some of these challenges, and in connection to that also discuss some of the proposed alternative ways of responding to these challenges.

The Swedish case

Before the banking crisis in the early 1990s, the cooperation between the Riksbank and the Swedish FSA (then the Banking Inspection) was limited to high-level contacts. In their day-to-day activities, however, the two authorities worked in different silos – the Riksbank with monetary and exchange rate policy and the FSA with regulating and supervising financial institutions. The crisis made it very clear to the Swedish authorities that there is a strong link between soundness of

financial institutions and macro financial stability, and hence a need for close cooperation between the FSA and the central bank.

This economic link is mirrored by a parallel link spanning at least three aspects of regulatory involvement in the financial sector – crisis prevention, crisis management and crisis resolution. In Sweden, these aspects of regulatory involvement are shared between the supervisor, the central bank and the Ministry of Finance.

In crisis prevention, the supervisor has the tools for regulating and supervising the institutions, while the central bank might play a supporting role through monitoring the stability of the system and the links to the real economy. In crisis management, the supervisor lacks the financial resources to back any intervention, while the central bank has the power to act as a lender of last resort. In other words, the likelihood that the central bank will have to provide liquidity support to a financial institution is partly determined by the quality of supervision. At the same time, the central bank may very well need the supervisor's analytical or informational support to be able to decide on whether or not and how to intervene. Finally, in crisis resolution, even if the Ministry of Finance takes the lead, it is likely to rely extensively on the supervisor and the central bank for advice and execution.

If we agree that there is a link between the soundness of institutions and financial stability, then supervisors must be interested in crisis management and resolution and central banks must be interested in certain aspects of supervision.

In the last decade, at least in Sweden, the macro and micro perspective have grown gradually closer. Indeed, the Swedish FSA now has an explicit interest in the stability of the system, while the Riksbank has taken a greater interest in the stability of single institutions, if they are judged as systemically relevant. We have regular contacts to share information and assessments and coordinate policy. If before, the relationship between the two authorities might have been described as polite but uninterested, it is now a mix of curiosity, some competition and frequent flirting.

The times they are a-changin'

This could have been the happy end of our story but recently there have appeared challenges to this set-up. All over the globe, the financial markets are becoming more integrated and financial institutions as well as financial infrastructure companies are consolidating domestically as well as cross-border. The challenge touches all the aspects of regulatory involvement – crisis prevention, crisis management and crisis resolution.

Cross-border integration of financial markets…

In the EU, the process of cross-border integration has been actively promoted by the creation of the euro and the ongoing harmonisation of regulation and supervision – in the last years epitomised by the Financial Services Action Plan (FSAP). Admittedly, financial markets integration in the EU has so far been a mixed picture.

Until now, integration has mostly taken place in wholesale markets, such as the money market and the bond markets. Many investment banking segments such as capital raising and mergers and acquisitions (M&A) for large corporates are

also dominated by global giants. In contrast, retail financial services are still to a very large extent controlled by domestic players, at least in the old member states.

… and institutions…

My guess is that we still have only seen the beginning of cross-border integration. Banking integration will probably not primarily take place through direct cross-border provision of services but through cross-border bank M&A. Integration of ownership will result in integration of lending/funding, organisation, products and services.

According to a study by the ECB, 43 banks and banking groups are active in more than three EU countries.[1] Only some years ago, cross-border banking M&A in the EU was only taking place between small countries or vis-à-vis the new member states – Austrian banks' expansion into some Central European countries is a good example of this phenomenon. Now this is changing. Today French, Spanish, German and UK banks are all trying to build European platforms. For instance, as you all know, Spanish Grupo Santander now owns the fifth biggest UK bank, and Barclays of UK owns the sixth largest private sector bank in Spain. And this spring, we are all witnessing the takeover battles, started by foreign bids, for two Italian banks.

…is good news for the economy but raises challenges to supervisors and central banks

At the Riksbank, we welcome this development. We believe financial market integration is strongly positive for economic efficiency and hence for growth and welfare in the EU. But we admit that integration presents some complex and multifaceted challenges to us as authorities.

At the outset, integration is obviously hindered by differences in language, business culture and national laws and regulations. But once it happens, integration tends to follow the logic of business, not the "logic" of country border or national law. For instance, for financial groups which are expanding cross-border a part of the synergies is derived from centralising functions. Hence, the group's credit risk model might be developed in the parent bank, while the group's liquidity is managed through a foreign subsidiary, and the group's derivatives trading is done in yet another subsidiary. That is why integration gives rise to a structure that often seems to be in conflict with the present regulatory structure. But the problem is not integration – the problem is that our regulatory framework is not designed for a single market for financial services.

Let me give you a concrete example of this. In the Nordic and Baltic countries – excluding Iceland – there are six banking groups with significant cross-border activities. Each one of these cross-border groups has regulatory contacts with seven supervisors and eight central banks.[2] It is commonplace to note that Western Europe is over-banked. It would not be outrageous to say that it is also over-crowded with regulatory authorities.

[1] Banking Supervision Committtee (2004), "Cross-border banking and its possible policy implications", December

[2] The Bank of Lithuania also has supervisory responsibility.

Our conclusion is that we, as national authorities in the EU, must solve the issues that integration gives rise to, rather than stopping integration. This might sound very obvious, but some of us authorities still only pay lip service to the idea of the single market. Or we love the idea of the single market as long as it means that our own banks survive as national champions and are able to expand abroad.

The question of how the relationship between financial stability and supervisory responsibility might evolve is a big and difficult one. Still, it is dwarfed by and will be determined by the question of which will be the shape of the relationship between authorities – central banks and supervisors – in different countries in the EU. It goes without saying that since laws and regulations and the division of responsibilities between authorities are ultimately decided by the governments of the member states, the challenge of integration inevitably also concerns finance ministries. I will now try to give some thoughts on the alternatives before us.

Back to basics

What will be the roles of national supervisors and central banks in an integrated EU financial market? If central banks and supervisors haven't done it before, cross-border integration will force them to think hard about their responsibilities, mandates and tools.

In order to do this, they will have to go back to the beginning and find their "raison d'être". What is special about the financial system and why are we regulating, supervising and monitoring financial markets and institutions? Who or what are we protecting and which tools do we need?

Whether authorities want to defend the status quo or reform the regulatory framework, they will need to prove their case to politicians as well as to each other. By itself, this might very well improve the way supervisors and central banks work. You may call this a positive external effect of integration.

Regulation and home-host issues

There are many issues at the table, but in the context of this presentation I would like to divide them into two categories.

The first category includes the issues of what regulations should be imposed on institutions and markets in the EU. How can we design laws and regulations that are flexible enough to fit all countries reasonably well, while strict and "harmonised" enough to support a single market?

The second category is essentially about the relationship between supervisors and central banks in different countries – the division of labour, power and responsibilities. This category of issues has come to be broadly referred to as the home-host issues. I will just give a short comment on the regulatory issues, while devoting the rest of my time to the home-host issues.

Regulation

Regulation on the EU-level first of all faces the same basic trade-off as on the country level. The Riksbank's view is that since almost all regulation involves costs – in terms of lower efficiency and growth – it should be the last resort and used only when there is a clear case of market failure. Some regulation is surely

SVERIGES RIKSBANK

needed to ensure a stable and sound financial system and necessary consumer protection. But too much or too strict regulation will give rise to new costs that are higher than the original costs that regulation initially aimed to address.

Regulation on the EU-level also faces another trade-off that is not present on the national level – that between the value of a *level playing field* and the cost of an overly detailed or inadequate regulation. A completely level playing field presupposes detailed rules that are applied in the same way in every market. But too detailed rules on the EU level risk being inadequate on the national level since national markets often differ widely. This could give rise to costly overregulation hampering financial development or driving financial institutions to settle elsewhere. Hence, it might be wise to leave some degree of freedom to the member countries. Historically, *institutional competition* has proved to be very positive for development in the long run.

At the same time, EU directives (as most international rules) tend to leave plenty of room for *national discretions*, effectively reducing the value of the convergence/harmonisation that probably was the motivation for the directive in the first place. We risk ending up with the worst of two worlds – very detailed rules on the EU level and loads of discretions on the national level. This makes the rules opaque and their implementation difficult to predict for the private sector. The starting point for EU rules should be the least common denominator. Today instead, it often seems like the starting point is the sum of all member states' national rules.

As national authorities we are all convinced that our national discretions are worth fighting for and we take pride when they are included in the final drafts. Perhaps we should ask ourselves more often whether our discretions are motivated by a fundamental need or just deep-rooted tradition or, even worse, our unconscious caving in to special interest groups. I realise this might be naïve but why not take this opportunity of change and think new instead of designing EU regulation on the basis of existing, often imperfect, national regulation.

The need for a *common rule book* for big cross-border banking groups is often raised by the industry. In principle, we are sympathetic to this wish. If a common rule book means "just" common rules we are certainly moving in that direction. One of the main objectives of the Committee of European Banking Supervisors (CEBS) is to promote convergence of supervisory rules and practices. However, in the sense of common or centralised decision making by authorities, I think it is still far away from coming true. As long as the implementation and interpretation of directives and rules is done on a national level it will take time before we have a common rule book.

Still, the aim should be to eliminate or reduce as much as possible these differences. Remaining differences in supervisory practices between countries should be clearly disclosed in order to improve the predictability of the EU regulatory system – which is another area where the CEBS is doing important work. Another practical example on how to reduce the regulatory burden would be for countries to agree on a common and centralised reporting standard for large cross-border groups.

The home-host relationship…

The home-host relationship is the underlying theme running through a number of issues in the regulatory debate. Broadly speaking, the home-host relationship is

SVERIGES RIKSBANK

about how we should divide tasks, powers and responsibility between different countries when it comes to supervising, monitoring and, in the worst case, sorting out financial institutions in distress.

Formally, the home-host relationship only refers to the division of responsibility between supervisors, which currently is based on the principle of home country control. The home country is the country where the bank is licensed. For a bank, this means that the home country is responsible for supervising the bank and its foreign branches. The home country's deposit insurance also covers its banks' foreign branches. In the case of a group, it means that the home country is also responsible for supervising the entire group on a consolidated basis, while the host countries are responsible for their respective subsidiary banks and deposits. At this very moment, the CEBS is drafting the so-called home-host paper giving guidance on how the home-host supervisory relationship should be arranged given existing EU legislation.

Even if there are no legally binding rules regarding the relationship between countries in crisis management or crisis resolution, these aspects of regulatory involvement have borrowed the terminology of the supervisory home-host concept. For example, when discussing lender of last resort in crisis management and burden sharing in crisis resolution we now talk about home and host central banks and finance ministries, respectively. This is natural, since legally the financial liabilities for a group are ultimately carried by the parent bank. Of course, a parent can choose to default a subsidiary, but it will then have to bear the capital loss. Subsequently, in practice, the ultimate public responsibility over a group rests with the home country.

... comes under strain...

At first glance, the home country principle seems very neat. But take a closer look and you will see signs that this set-up was not designed for a fully integrated market. Essentially, there is a gap between, on the one hand, legal powers and mandates and, on the other hand, de facto abilities and responsibilities. Home countries are given powers over branches and subsidiaries but might be unable or unwilling to use them, while host countries are losing powers that they have been willing to use. This gap becomes a problem once you have a banking group or bank that is systemically relevant in a host country (see table 1). Even if there are not so many of these cases yet, I am convinced that the number will increase. The potential conflicts of interest and coordination problems are of many kinds. Let me give you some examples:

Table 1: The home-host relationship (both bank and group)

	Systemic relevance in HOST country	
Systemic relevance in HOME country	Significant	Non-significant
Significant	Potential conflicts of interest and coordination problems	Not a big problem
Non-significant	Potential conflicts of interest and coordination problems	Not a big problem

… when branches and subsidiaries become systemically relevant

Suppose there is a banking group of roughly equal systemic relevance in the home country and the host country. The home country supervisor is the consolidating supervisor and coordinates the activities vis-à-vis the group. If cooperation works well, the host supervisor will receive information from the home supervisor. But in the event of a crisis in the banking group, all authorities have a clear mandate to only protect their depositors and systems. One can easily imagine a situation where, as in my earlier example, the group has surplus capital in one of its parts, extra liquidity in another and the cause of the problem is in a third part. The lack of coordination might very well result in a worse (more costly) outcome for all involved.

If the presence in the host country is a branch and not a subsidiary, the host supervisor has only limited means of obtaining information about – or taking actions against – the bank. In the event of a crisis it can only hope that the home country will take the host country's situation into account when managing the crisis. The home country, on the other hand, faces a situation where it could be necessary for its central bank to provide emergency liquidity assistance (ELA) to support a bank which has a large part of its activities in other countries. Should the bank need to be reconstructed it would be the home country's tax payers that would have to foot the bill – either by supplying the necessary capital to the bank or by supporting the deposit guarantee system with the funds needed to pay out insurance to the bank's depositors.

The imbalance between home and host countries may be further deepened by differences in size between the two countries. One case will be that of a big home country and a smaller host country. The banking group's exposure to the host country is then probably relatively small on a consolidated basis. This results in the home country authorities spending relatively limited resources – in terms of staff – on the foreign subsidiary's activities in the host country. If such a banking group runs into problems, the home country authorities will not necessarily view it as systemic, while the host country authorities certainly will do.

How to deal with the home-host asymmetry?

In all these examples host authorities have a legitimate interest in being able to influence supervision, share assessments and have a say in the event of a crisis situation. They have been given the task of protecting the soundness and stability of their financial sector and the general public in the host country will rightly expect their authorities to be able to do this. At the same time, the home authorities should have an interest in sharing resources in crisis prevention and risks and costs in crisis management and resolution with the host countries. In the current setting, however, this is only possible to a very limited extent.

First, there is a need to share information between the home and the host. This should be the least difficult, but in practice everyone who has tried to share information between authorities knows it can be a complicated and cumbersome process, at least until there is an established routine. Even when there are no confidentiality concerns there are many practical obstacles to overcome. Information sharing is not only about sending data back and forth, but more importantly, it is about explaining information and sharing assessments. As long as hosts are under the impression that they know a lot less than the home, it will be very tricky to cooperate.

Second, there is a need to cooperate on actions vis-à-vis the bank or the group and its components. If hosts cannot influence the process of supervision or crisis management, their trust in and use of the information from the home authority will be very limited.

Sharing information and cooperating on regulatory actions may be problematic already in normal times, but is probably much more difficult in a crisis situation when economic risks and costs are clearly visible. So far, cooperation and coordination in crisis situations is dealt with in the EU by various Memoranda of Understanding. Even if these MoUs are not legally binding, they are valuable documents. They provide a basis from which more operational crisis cooperation agreements can be developed by the countries and authorities that see the need to do so.

But looking at this increasingly complex patchwork of supervisory colleges, central bank networks and MoUs that we are now creating, one cannot help to wonder if there are not any better alternatives for cross-border cooperation.

Future alternatives to the home-host model

What are, in the long term, the alternative models to the current home-host set-up? In the EU, we are committed to creating a single market for financial services. If we take off our national central bank and supervisor hats, are we really convinced that the home-host model is the best one in the long run?

After all, several serious alternative models have been suggested. The pros and cons of the three main models are reviewed in an interesting paper by Oosterloo and Schoenmaker.[3] I will briefly comment on these.

Three alternatives for supervision

The first alternative is to give the home supervisor the role of *lead supervisor* with full responsibility for EU operations, branches as well as subsidiaries. This is the proposal from the European Financial Services Roundtable (EFR). The lead supervisor would be the single point of contact for reporting and would validate and authorise internal models, approve capital and liquidity allocations, decide about on-site inspections. In short, the lead supervisor would have full supervisory responsibility. The role of host supervisors would be as advisers in a college of supervisors. However, host supervisors would have no formal power. Also, when it comes to financial stability and crisis management, the lead supervisor would only have a national mandate. Thus, there would still be a need for cross-border regulatory cooperation.

The second alternative, which is put forward by the two authors, is to give the home supervisor the role of *lead supervisor with an EU mandate*. The lead supervisor would work as in the EFR model, with the difference that the lead supervisor is given a "European mandate to ensure that the interests of all depositors/countries are taken into account". In this model there is a decision-making agency of European Financial Supervisors at the centre, which is delegating the task of supervision to each respective home supervisor. Regarding financial stability issues, the home country central bank would also be involved, acting on behalf of the European System of Central Banks (ESCB).

[3] Oosterloo and Schoenmaker (2004), "A lead supervisor model for Europe", *The Financial Regulator*, Vol.9.3, 34-42.

SVERIGES RIKSBANK

- The third alternative is both the most obvious and the most radical and would be to create a *European Financial Supervisor* (for example put forth by Breuer). This simply means having one authority acting with full supervisory powers over branches and subsidiaries of cross-border European banks. The system could be tiered (like in the US) in the sense that the EU supervisor would only be responsible for banks and banking groups with significant cross-border operations, while purely domestic banks could remain the responsibility of the national supervisors.

A European Financial Supervisor

All three of these alternatives, even the first one, are considerably more far-reaching than what is currently under construction. I do not think many authorities find the first alternative with a lead supervisor very appealing. It addresses the problem only from the cross-border bank's perspective of minimising the regulatory burden. This is important but does not solve the underlying conflicts of interest between the home and the host countries. In short, it is a model which will only work in normal times when the weather is nice, if even then. The second alternative – the lead supervisor with an EU mandate – seems nice in theory and aims at solving the conflicts of interest by creating a central decision-making body. In practice, however, it could easily become very bureaucratic and inefficient. If we are establishing a central decision-making body anyway, why act through 25 different authorities? Both the first and the second alternatives are half-way compromises trying to please different interests. My own view is that the third alternative, although radical, is the logical solution. There are two main arguments against the idea of a European Financial Supervisor – one relevant and one not very relevant.

The not very relevant argument is that the supervisor needs proximity to have knowledge about the markets where the institution operates. First, this is already a problem with the home-host model. Second, this is an organisational problem that can be solved. An EU supervisor would certainly employ staff from all EU countries and have local offices in the national financial centres. For instance, for a regional cross-border banking group, I imagine the supervisory team to be based in the relevant region, perhaps in the same premises as the national FSA, and to consist of staff from that region.

The relevant argument against an EU supervisor is that supervisory power ultimately needs to be backed by financial muscle. In the present set-up, the financial muscle derives from the national central bank's ability to act as a lender of last resort and the government's ability to raise taxes. The EU lacks such power.

However, this problem is hardly unsolvable. For instance, one could think of the EU building up a deposit insurance fund for cross-border banks supervised by the EU supervisor, which would be able to handle all but the largest banking failures. In fact, such an EU fund would be better diversified than the national funds are today, which all else equal would enable it to charge lower fees or hold a bigger risk-adjusted buffer. In the event of really large banks or several large banks failing, there could be an established system of committed drawing rights, where the EU fund has the right to raise funds through national governments' ability to raise tax. Regarding liquidity support, the ECB would be given the role as lender of last resort.

SVERIGES RIKSBANK

- To convince national governments to commit such guarantees would of course demand very strict and well thought-out rules governing what actions the EU fund should be allowed to take in the case of a bank failure. These rules could be inspired by the US FDIC's very strict mandate to always choose the least cost solution. Among other things, this would in some cases mean allowing shareholders as well as uninsured depositors and debt holders to lose their money. Since to my knowledge most EU countries lack the rules on how to handle large bank failures, it would also be very positive from a contingency planning and moral hazard point of view. With a strong legal framework, the EU would be able to let investors in even the biggest banks take full financial responsibility.

Concluding remarks

I remember once hearing Tommaso Padoa-Schioppa, the outgoing member of the executive board of the ECB, saying that there is no need for a European supervisor if national supervisors can prove that, when needed, they are able to act as one. Personally, I find it hard to see how, in the long run, the EU could avoid establishing an EU financial supervisor. At the moment, we are spending considerable supervisory and central bank resources on trying to construct arrangements that will enable us to work and act as one. Why not instead become one, and spend the resources on supervision and monitoring?

Coming back to the title of this address, I would like to conclude that even though financial stability and supervision has been divorced in most EU countries there are few reasons to expect the life of central bankers and supervisors to be very stable in the coming years. It will probably not happen overnight, but the integration of European financial institutions and markets will eventually mean big changes also for the financial authorities. To ensure a good outcome for the European financial market, central banks and supervisors will have to be flexible and reinvent their roles and tools.