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## **The supervisory convergence in Europe – experiences and potential future structures<sup>2</sup>**

### **I. On supervisory convergence**

Supervisory convergence usually means two different things. On the one hand, it means regulatory convergence that determines the legal framework for the supervisory activity. On the other hand, it means supervisory convergence related to the implementation of the concrete supervisory activity and methodology. The growing need for regulatory and supervisory convergence is a natural phenomenon on the increasingly uniform financial markets. Such a convergence is required by the supervised institutions themselves, since adjustment to several different national rules and supervisory practices – which is a complicated and resource intensive task – on the theoretically single market of the European Union poses a serious difficulty for institutions or banking groups active on the international markets. Supervisory convergence is also required by the supervisory authorities, since the information gaps caused by the differences in the national supervisory systems are difficult to bridge. Consequently, the supervisory authorities often lack sufficient information on institutions the prudent operation of which is their responsibility. Adjustment to the different standards is a cumbersome and costly process for the banks, and is also detrimental for the consumers, since they must pay the costs of adjustment incorporated in the price of the products.

From the perspective of the supervisory authorities convergence is especially important for countries the markets of which have been penetrated by the financial groups of many countries, or whose institutions have settled in several member states of the EU, since in these cases they must cooperate – either as a host or a home institution – with supervisory authorities working in different legal frameworks and applying different supervisory cultures. The Hungarian market is an open financial market that welcomes a great variety of owners (bank owners include Austrian, German, Italian, Belgian, Dutch and French nationalities, too), while the Hungarian national champion itself is the centre of an international group, the subsidiaries of which can be found in several new EU member states. The issue of convergence is made important not only by the market players, but also by the operation of the

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market, since the Hungarian banking market practically offers the same products and services as the banking market of any other EU member states, and although most banks have settled in Hungary through subsidiaries, the financial groups are often characterised by a uniform internal procedure, or centralised product and IT development.

However, convergence is not only a question of market and supervisory technique. It is also a political issue, since rules and supervisory practices can be standardised only through compromises, which require all parties to make concessions and limit their respective national practices that they all regard the best.

The following sections provide an overview of supervisory convergence related issues from the perspective of banking supervision. However, it must not be forgotten that supervisory convergence is not only a banking supervision issue, but also one that arises in connection with the supervisory convergence among different financial sectors (insurance or capital markets).

### ***Convergence in regulation***

Banking regulation in the European Union is based on directives regulating the activities of the banks. For the time being, the directives set minimum harmonisation requirements for the national regulatory authorities, i.e. they determine a framework that ensures operation based on identical principles and similar partial rules, but they do not provide a completely uniform regulatory environment due to their different national implementation. Therefore, financial groups that are active on several national markets of the EU operate in an environment that is uniform on the level of the directives, but different on the level of the partial rules and the applied practices. However, the directives set prudential requirements only for the banks. Regulation is much more divergent in other fields of the economy. For example, corporate laws, corporate bankruptcy and liquidation laws, or taxation rules significantly differ from member state to member state.

Considerable differences in regulation are also caused by the fact that some of the EU member states are common law, others are civil law countries. Hungary's legal system is excessively based on civil law, which can be well observed in the implementation of the CRD in Hungary. Whenever the CRD says "subject to the discretion of competent authorities", "subject to the approval of competent authorities", "demonstrated good cause", "does not materially depend", "significant", "non-significant", "material" or "immaterial", the Hungarian regulation always contains a more concrete stipulation upon the extremely firm request of the Hungarian Ministry of Justice, which is responsible for the enforcement of the basic principles of legislation and the consistence of the legal system.

*Although the list of the relevant examples is long, I would just like to cite a few of them. While the second pillar of the CRD is designed to ensure the adequate level of economic capital, and consequently, there is no relevant regulatory limit, the Hungarian regulation prescribe that its amount cannot exceed the capital requirement of the first pillar. Or, for example, in the ASA method used for the assessment of operational risks, the Hungarian equivalent of the "significant proportion of its retail and/or commercial banking activities comprise loans associated with a high PD..." is at least 50 per cent in the case of a "significant", and at least 3 per cent in the case of a "high PD". In relation to the possible reversion to the standard method from the IRB method the CRD stipulates that "institutions using IRB shall not revert to use of STA except for demonstrated good cause." In contrast with this, the Hungarian regulation lists the three concrete cases of possible revert (merge or separation of institutions, misleading risk profile given by IRB or vis major.)*

Apart from the different implementation of the uniform rules in harmony with the national legal systems, several national discretions incorporated *a priori* in the regulation also severely diminish the possibility of regulatory convergence. (AT present there are more than 150 national discretions in the CRD.) Although the reduction of national discretions is also on the agenda in relation to the modification of the CRD, there is no real possibility for their complete liquidation.

### ***Convergence in supervision***

The quest for convergence in European banking supervision has a much shorter history than that in regulation. The European Union approved the so called Lámfalussy Report in November 2002, as a result of which the Committee of European Banking Supervisors (CEBS) was set up in 2004. The main objective of this committee is to foster supervisory convergence. Its main tools include the issuance of guidelines mandatory for all supervisory authorities of the European Union, as well as supporting the development of principles and standard practices for the national implementation of community regulation.

During the short period of time that has passed since its establishment, the CEBS and its subcommittee have done a lot for the implementation of EU level supervisory convergence. They have issued guidelines in several fields of regulation that are of extreme importance for harmonisation (prudential filters, supervisory disclosure, COREP, FINREP, ECAI, SREP-ICCAP, home-host cooperation, validation, outsourcing, mediation procedures). Furthermore, they operate several schemes that support convergence during the concrete supervisory work. The CEBS hosts the so called supervisory colleges, which serve as umbrella organisations for the supervisors of internationally active banking groups, and formulate a uniform standpoint on issues raised in relation to the supervisory activities of the different groups on the basis of consultation. They try to answer questions raised in relation to the validation of

developed methods in the fields of NOVI-C and NOVI-O (Network on Validation Issues Credit risk and Operational risk) from a uniform perspective.

In addition to the CEBS, supervisory cooperation and convergence within the European Union have several forums, the framework of which is created by the MoUs of the authorities. In connection with the approval of developed methods, bilateral or multilateral MoUs serving the international coordination of the licensing process of the developed methods of the international banking groups (in addition to the leading role of home supervisory authorities) have been concluded in line with Art. 131 of the CRD. However, one can also mention the MoU that was signed on crisis management by most of the EU member states, and was renewed at the beginning of April 2008. This MoU provides a functional framework based on uniform principles for the activities of finance ministries, central banks and supervisory authorities during a potential financial crisis that affects banking groups engaged in cross-border activities.

The above listed steps represent significant progress, however supervisory convergence has apparent limitations. As long as the supervisory authorities work under different legal systems and rules, differently used national discretions and different, but increasingly harmonised methods, and as long as the different rules and methods are accompanied by different reporting systems, convergence can be nothing but partial.

### ***Why do we need to move forward? – Challenges***

The supervisory authorities do not only serve the prudent operation of each supervised institution, but also act in the interest of the public good by supporting financial stability. If the supervisory schemes operated in the European Union are not in line with the specific features of the market, they do not reflect its level of integration, they cannot efficiently serve the public good.

1. According to the above written, the number one and maybe the most important cause of the need for the further strengthening of supervisory convergence is that although serious progress has been made in the past years in the field of supervisory convergence, the basic problem is that the increasingly internationalising markets are governed by different national rules and different national supervisory practices.
2. In the opening lecture of the conference at which the presentation, serving as the basis for this paper, was given, Fernando Montes-Negret<sup>3</sup> introduced the audience to the regulatory consequences of the current sub-prime crisis with

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<sup>3</sup> Fernando Montes-Negret, Sectoral Director, The World Bank: Centrality of Liquidity & Leverage in Diverse Intermediation Models

a quotation from Paul Volker, dated April 2008: "For financial regulation in general, competition in regulatory laxity cannot be a tolerable approach". This quotation recalled me to a paper written by Peter Cook, head of the working group trusted with the elaboration of the first generation of the Basel capital rules, in which he argued for the need for internationally uniform capital rules<sup>4</sup>. In his opinion ".....disparities in national regulation as regards both the way in which capital adequacy is measured and the amount of capital which banks are required to hold, can have several harmful consequences. ....pressures can make it difficult for individual national supervisors and individual banks to maintain, let alone raise prudential standards. Instead all the pressures will tend towards 'competition in regulatory laxity' ..."

The subject matter of the two quotations is the same. It implies that it is a natural concomitant of the international competition among the supervised institutions that the institutions exercise a great pressure on the regulatory and supervisory authorities of the individual countries to make them operate a regulatory and supervisory environment which does not hinder financial expansion and innovation, and which provides more competitive edge and less disadvantage to the institutions. Expansion and innovation, which do not seem to be too risky in the ascending phase of the economic cycle, may imply risks of unknown quantity and nature in the descending phase of the cycle. Therefore, it is important that the regulatory and supervisory authorities should not let themselves be convinced that strict regulatory and supervisory practices are unnecessary, and they only cause a competitive disadvantage to the national institutions. If this happens, "competition in regulatory laxity" may evolve, which has proved to be harmful several times during the recent economic history. As long as regulation and supervision are performed in national frameworks, the relevant pressure will obviously persist.

3. The financial turbulences that originated from the sub-prime crisis of the US, and which have spread to Europe, too, have clearly indicated that financial crises are no longer deemed to be isolated events that occur within national boundaries. The crises are unaware of the national borders. If an internationally active credit institution gets in trouble, several national authorities of several countries must cooperate to resolve the crisis. In case several credit institutions of a country are affected by the crisis, the number of authorities to be involved in crisis management, information exchange and the reconciliation of supervisory measures can be unmanageably high. This

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<sup>4</sup> Peter Cook: International Convergence of Capital Adequacy Measurement and Standards In: The Future of Financial Systems and Services, Edited by Edward P.M. Gardener, Macmillan, 1990.

situation is at best facilitated, but is not made easily manageable by the system of MoUs that require internationally standard procedures.

4. The crisis management of an internationally active financial group requires adequate international mechanism of fiscal burden sharing. The national safety net systems are different and the related MoU on crisis management gives just some general principles and not a concrete method for burden sharing. Personally I sympathize with the three level system proposed by Leszek Pawlowicz on the division of the cost of a cross-border banking crisis<sup>5</sup>. Anyhow the question of burden sharing has to be answered.
5. Adjustment to the different national rules, supervisory procedures and reporting requirements is rather detrimental for the cost-efficiency of the institutions. And naturally, the costs of adjustment must be paid by the users of the services. This extra cost reduces social welfare.
6. In the current, fragmented supervisory structure the information available on the different groups of institutions is fragmented, too. Although supervisory convergence has several tools at its disposal – already today – that can make information sharing work, in such a fragmented environment it is very difficult to elaborate an information sharing mechanism that would provide an efficient, friction and asymmetry free information base for supervision.

### ***The possible ways for moving forward***

In the past period several paths have been outlined for the further development of supervisory convergence. Several articles, lectures, semi-official and official proposals have been presented.

The representatives of the EU member states have submitted three different proposals to ECOFIN.

Alistar Darling, the Chancellor of the Exchequer of Britain has argued that the way forward should be based on the significant further development of the current supervisory colleges and the reinforcement thereof by EU regulation, and the elaboration of a European supervisory network on that basis. In this system, the activity of the supervisory colleges would be supplemented by the cross border stability groups, which would include, in addition to the national supervisory authorities affected by the colleges, the central banks and the finance ministries of

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<sup>5</sup> Who will pay for a banking crisis on the European Financial Market? A host country's perspective ,In: Who will pay for a banking crisis on the European Financial Market? A host country's perspective, Edited by Prof. Leszek Pawlowicz, The Gdansk Institute for Market Economics, 2007.

the same countries so that cooperation among all the affected parties should be efficient in case of potential crisis situations.

According to the proposal tabled by Italian Economy and Finance Minister Tommaso Padoa Schioppa, supervisory convergence can be achieved via the reinforcement of the L3 Committees, the transformation thereof into a European Agency, as well as through the elaboration and application of the Single European Rulebook. The Single European Rulebook would create the tool for the uniform interpretation and implementation of level 1 and level 2 rules at the level of the European Union.

Hungarian Prime Minister Ferenc Gyurcsány proposed the establishment of a Single European Financial Supervisory Authority (EFSA). This proposal is not based on the further development of the current structures, but envisages a new, European level institution conform to the specific features of the common European financial markets. Since it is clear that the current economic and regulatory environment would not be able to host such an institution, an integral part of the proposal is the establishment of the European Financial Supervisory Institute (EFSI) to prepare the organisation of the new authority.

### ***The Single European Financial Supervisory Authority and the European Financial Supervisory Institute***

The EFSA could respond convincingly to most of the challenges posed by the single market. From among the proposed solutions this is the one that can achieve the highest level of convergence, since it would delegate level 3 regulation and supervision to a European institution. This can be a good solution for banking groups engaged in international activities, since then they would need to maintain relationship with the EFSA only, and not with many national authorities. Requirements for the groups would be set by the EFSA, reports should be delivered to the EFSA, and it would be the EFSA's responsibility to validate the developed methods of the CRD, to conduct the ICAAP-SREP dialogue, etc. The single channel supervisory relationship is more cost efficient, and consequently it serves social welfare better than the current, fragmented system. The EFSA, as a federal solution, would stand above national interests, and thus it is superior to the proposals based on national frameworks in terms of the "competition in regulatory laxity", too. It solves the problems arising from the fragmented nature of information and the differences between the reporting systems. As a European institution it would be able to concentrate the best professionals of the European Union, therefore it could be a major intellectual workshop for the further development of regulation and supervision.

In relation to supervision, the above sections discussed the supervision of financial institutions in general, and concretely banking supervision. The supervision of financial market participants in the EU member states is not uniform in that the different

financial sectors are supervised by separate institutions, or integrated supervisory authorities are responsible for the supervision of banking, capital market, insurance and pension fund activities. Therefore, it is still to be decided whether the EFSA should be a European banking supervisory or integrated financial supervisory authority. Due to the integrated nature of the financial markets and risks, and due to the fact that most EU member states have an integrated supervisory authority, it is justified to set up the EFSA as an integrated supervisory authority. Otherwise, the EFSA would be a setback for several countries in terms of the integrated approach and risk based supervision compared to the current situation, which lacks all grounds.

However, it must also be seen that the problems that hinder convergence cannot be solved merely and immediately by setting up the EFSA. Therefore, the establishment of the EFSA must be preceded by thorough preparatory work, in the course of which the obstacles to the establishment and operation of the EFSA are systematically explored and removed. A good example for the preparation of the organisation and operation of a single European institute in the EU is the European Monetary Institute, which performed a similar work for the preparation of the establishment of the ECB. Analogically, the EFSI could be set up to elaborate the operation of the EFSA and give the answers to the arising questions without which operation cannot be started.

### ***Summary***

The transformation of the supervisory structure of the European Union is inevitable. In the longer run, the establishment of the EFSA may provide a good solution to many challenges posed by the integrated financial markets. However, there still exist several obstacles to the organisation and proper operation of the EFSA. The gradual way of removing the obstacles and setting up the EFSA can be through the establishment of the EFSI.

However, even before the EFSA starts functioning, there are several possibilities to strengthen supervisory convergence. The supervisory colleges and Level 3 committees have achieved serious progress, and by further developing their activities they can do a lot for strengthening supervisory convergence in the future, too.