The Consolidation of Banking Supervision in the Context of a Pan European Banking System

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Abstract. *The diversity of national banking systems in the European banking system and the absence of consolidated supervision creates the premises for a series of interrogations whose essence is the same: Is it possible to discuss about a Pan European Banking System? The starting point in answering this question was the efforts to create a single banking market, which took place in 1973-1999, and the impact of integration on the European Banking Industry. Among the most representative aspects, it must be emphasized the necessity of consolidating banking supervision at an European level, considering that the International Banking Community studies the problematic of banking regulations at a global level. The two dimensions of the prudential and European bank supervision device – the geographic and the institutional – demand the creation of a structural reform in order to ensure the functioning of a Pan European system of banking supervision and regulations.*

The considerations on the Consolidation of European Banking Supervision draws into discussion the Financial Supervision Authority which has generalized as an applicable model in numerous European countries and has been mentioned as an alternative of Pan European banking supervision.

In the process of the integration of the banking sector, the Basel II Accord represents an opportunity in reaching a convergence of national regulations and practices in matters of risk management, considering that these actions are in line with the preoccupations of realizing a Pan European banking system. Thus, the creation of Pan European banking system involves actions in more directions: legal, institutional, operational meant to ensure the consolidation of banking supervision.

Key words: consolidation; banking supervision; Pan European banking system; banking harmonization; Basel II Accord.

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The European Financial Integration is a subject debated, emphasizing the component of capital mobility and integration of capital markets and less on the banking system component.

As opposed to the European capital markets which have an increased degree of integration and registered favorable evolutions in the field of harmonization legislation, stock market products, capital market instruments, mergers between stock exchanges (EURONEXT 3 and EURONEXT 5), banking systems are in the paradox situation of presenting particularities at a national level, such as consumer culture and the preferences of domestic customers, the costs of banking services and products, the national regulations, the institution typology. In consequence, the following interrogation is justified: “Is a Pan European banking system possible?” If the answer would be affirmative, then the next logical question would be: “Which will be the architecture of such a Pan European system?”

At the beginning of 2006 in the European Union there were approximately 8300 commercial banks and over 30,000 specialized credit institutions, quantitative aspects which may constitute an argument in the competition with USA’s banking system. What chances have these banking entities stand, considering that some of them own a market share of under 0,01%? What is going to be their option for banking universality or specializing, and how will *the intensely fragmented character of banking supervision* will be eliminated, how costs, interests rates practiced by banks shall be aligned are challenges for the European Banking.

A reality that can slow down the process of financial integration, the diversity of national banking systems and the lack of a consolidated supervision constitutes a preoccupation at the level of European authorities, considering that this national aspect of the European banking systems is in opposition with the unique monetary policy undertaken by European System of Central Banks.

Stages of harmonization of European banking systems

The process of integration of banking systems of member states of the European Union and the creation of *a Pan European banking system* needs to bring in discussion the efforts to create a unique banking market which can be highlighted through the following *legal and historical guide marks*:

- 1973: the directive regarding the abolishing of restrictions regarding the freedom of establishing and ensuring of services in the domain of banking activities and other financial institutions. These regulations were referring to the staff of financial-banking institutions;
- 1977: The First Banking Directive named “The Coordination of Legislating, Regulations and Relative Administrative Provisions at the Creating and Monitoring of Credit Institutions” gradually introduced the principle of control by the origin country. The document was about harmonizing banks in Europe, without offering suggestions regarding the way this issue shall be done, which rendered the harmonization difficult in this moment;
- 1986 – “The Single European Act” acknowledged the harmonization of markets as being difficult and provisioned the elimination of control over capital;
- 1989 – As a response to the 1986 document the 2nd Banking Directive was adopted, through which specific recommendations were established in order to create a single banking market within the European Union. The directive has introduced the principle of mutual recognizing, which replaced the concept of harmonization with the one of “European business passport”. Thus, banks and financial institutions acknowledged in the member states are capable of operating and offering services in any other member state, without the need of a special authorization of the host country. The 2nd Banking Directive has also made possible the creation of banking conglomerates, respectively the orientation towards *universal banks*, as compared to specialized banks in the US.

Presently, the European economic climate is totally changed, thanks to globalization, deregulation, disintermediation, geographic diversity and advanced technology, which plays an important role in the process of mergers and acquisitions. The reasons for which in the European Union strategies of mergers and acquisitions were adopted were that of deteriorated performances, defensive managerial reasons as compared to the synergy effects traditionally envisioned through mergers.

The European Union needs more operations of this type, and although the banking system has reached a high degree of financial integration, additional progress is necessary. The difficulties in this field are manifested due to the differences between fiscal and legal regulations, as well as different standards for banking infrastructure and products. Despite these obstacles, European banking integration may cite the largest trans-border transaction, the taking over of HVB by Unicredit Bank Italy.

Regarding *the impact of European Integration on banking systems*, *three main features of the banking institutions* stand out, on which the integration didn’t have considerable effects:

- Manifestation of banking risks, and especially of the systematic one, which leads to an emphasized regulation and supervision, but being strongly fragmented.

▪ Manifestation of asymmetry of information due to the traditional activities of banks of issuing credits.

▪ The Customers' commitment towards banking services and institutions, which demonstrates that the customer's commitment to banking institutions are manifested according to the easy access to banking services and less due to reasons of profitability and efficiency of banking activities.

These features favor the development of domestic banking markets in increasing the process of concentration through mergers and financial absorptions inside the country and less outside its borders. In this condition, a Pan European banking system is harder to design. This idea is sustained by the results of surveys undertaken by specialized institutions which proved that relationships between customers and banks are long term lasting, comparing to other services, and competition is less intense. Thus, if we ask that a Pan European banking system is possible, the answer is negative, as most of the customers are happy with services offered by the banks in their countries and they prefer the domestic banks, and they do not want to appreciate the emergence of Pan European banks.

A study conducted by KPMG, based on the opinions of 2300 bank customers from 10 countries (France, Germany, Italy, Spain, Netherlands, Sweden, United Kingdom, Czech Republic, Poland and Switzerland), highlighted the following situations:

▪ Most of the consumers don't want to create a Pan European banking system;

▪ Among the customers, there isn't a good knowledge of foreign banks (only half can name a foreign bank, Deutsche Bank being representative for Germany and HSBC for UK);

▪ 78% of the customers trust the services offered by their banks, being very satisfied;

▪ When asked which are the 3 main characteristics of domestic banks, the customers emphasized: low costs, good "internet banking", competitive interest rates.

The process of European integration has brought, ever since its debut, a new perspective for European Banking Industry, analysts expecting that banks and processes of financial intermediation to become more uniform and in the field of competition to register essential modifications, as well as in banking supervision and regulation.

Regarding these expectations, the evolutions of banking systems in European countries highlighted a series of characteristics which differentiate European banking industry of that of the United States. Thus, while in the United States of America the process of local banking concentration is decreasing, in Europe, mergers and acquisitions between commercial banks are increasing, which configures a certain market structure, with effects on the mechanisms of transmitting the monetary policy. The tendency of domestic, national consolidation makes that those banks that own an insignificant market share to orient to an international consolidation. Referring to the activity of banking supervision, in a traditional way, this was oriented to the quality of balance assets, minimum capital requirements and portfolio structure. This approach, however, is no longer adequate when banks are active players on the capital market and losses incurred from transactions with portfolio owned titles can quickly lead them to insolvability situations.

In the European Monetary Union the survival of banks which face market risk depends on the capacity of central banks to provide liquidities to the financial system and the banking one in particular. From this point of view, the Central European Bank, as opposed to the Federal Reserve System, is more focused on the problem of risk and providing liquidities to banks.

European bank supervision must be centralized, because the actual decentralization of supervision brings about a series of risks. A series of events such as Pan European emergence of universal banks and the new competitive climate in the banking field could cause that the national survival be confronted whit serious problems.

Such a consolidation is the more necessary as the international financial community studies the problematic of a *world wide banking regulations*, a paradox being that this doesn't happen in the European Union.

The consolidation of banking supervision

At the present time, the prudential device and European banking supervision has a strong decentralized character, as opposed to the unique monetary policy in the Euro area thanks to the 2 definitive dimensions: *geographic* and *institutional.*

From a geographical point of view, in the field of banking supervision the principle of *subsidizing* is functioning, which means that national authorities of banking supervision own the competencies in the field of banking control.

Geographic separation of the prudential control of banks resists and still resists the process of monetary integration, considering that the provisions of the Maastricht Treaty have only marginally approached this aspect, so that if the European deciders won't rule for decentralization of banking supervision, the state of things risks to go on for a long period of time. As an argument in favour of such a state, *the European market of services is not homogenous integrated* in regulations and accounting rules.

Another fundamental dimension of European banking supervision is represented by *institutional anchoring*, principle dating form the 1930's and reconfirmed after 1945. On the basis of this institutional segmentation, the supervision of credit institutions implies one or more authorities of national supervision.

In this way, the European prudential device is double segmented, at the institutional level and on the international level, which emphasizes *the profound dispersed character of banking supervision*. To confront such a reality, the solution is the way of the reform, on the basis of inter and intra-national cooperation.

The necessity of consolidation of banking supervision arises much more with the manifestation of a certain ambiguity which creates uncertainties in the systemic crisis in case of the European Monetary Union. Thus, in 2000 were formulated a series of opinions regarding the impact of an asymmetric shock in the European Monetary Union area. If a banking crisis would affect the entire Euro area or in the hypothetical situation that a national banking system would register major losses, which would be the margin for maneuver of member states? The action capacity of those states would remain limited, because The Stability Pact conditions the awarding of public aid considering several criteria, and on the other hand, the resort to a monetary policy based on the general decrease of the interest rate in the Euro area doesn't appear to be applicable. If a national central bank of a country affected by banking crisis awards additional liquidities to banks in the system, this assistance in liquidities is, according to regulations, incompatible with the centralized monetary policy of the European Central Bank.

Facing this state of things, the obvious solution is undergoing a *structural reform*. The ones responsible with European banking regulation presents a multitude of arguments in favour of maintaining decentralized control, which creates a lot of shadow areas, amongst other things compromising European banking and financial security. In other words: What would be the price for ensuring European banking security? is a question whose answer would be to ensure the functioning of a Pan European supervision and banking regulation system. This solution seems to be more appropriate in the present conditions of financial systems dynamic, financial globalization and suppressing the frontiers between institutions and markets, which needs a ever increasing cooperation between control authorities.

Considerations on the accelerated consolidation of European banking supervision brought under discussion the model of the *Financial Supervision Authority*, as a regulating and supervision institution. Referring to this subject, it must be mentioned that there are three *models for organizing banking supervision:*

a. the model of the Financial Supervision Authority or its equivalent;

b. model of the Central Bank;

c. model of the Ministry of Finance.

a. *The model of the Authority of Financial Supervision.* It is applicable in the Scandinavian countries (Denmark, Sweden, and Finland) but also in Belgium, France, Germany, Luxemburg and Great Britain, and it supposes that the prerogatives in the field of banking supervision to be drawn out of the jurisdiction of the Central Bank and to be handed out to an institution with the ability to conduct a consolidated supervision for the whole financial market. This first model presents considerable differences from one country to another, due to the competencies field, respectively to the area of containment in the supervision activity.

b. *Model of the Central Bank*, more homogenous than the previous, shows that banks have the complete responsibility in what concerns the supervision of banking system. Within this model two groups can be distinguished: the countries in Southern Europe and the Low Countries. In Spain, Portugal, Italy and Greece, the central bank plays an essential role in the supervision of the banking system, and the prerogatives of this institution are complete. In the Low Countries, the prudential device has the merit of being simple; the central bank plays a role in supervising, solving bank crisis and administrating the mechanism of guaranteeing deposits.

c. *Model of the Ministry of Finance*. This institution fulfills an unequal and indirect role, excepting Austria, where the Ministry of Finance is the main authority engaged in supervising the banking system and solving crisis.

In consolidating banking supervision in Europe, what model should the institutions in the field should adopt? Regarding this subject, 4 scenarios were considered:

▪ *Scenario 1*: *The European Central Bank* may run for the position of supervising institution of the European banking sector. Such a solution would be valid in case the national banks wouldn't have direct and indirect attributions in the prudential control. The pro of the scenario is the high credibility of the European Central Bank in ensuring monetary stability, and the con is the possible erosion of credibility in case of manifestation of banking crisis.

▪ *Scenario 2:* the distribution in the member states of the model of the *Authority of Financial Supervision,* which means the withdrawal of the control prerogatives from the field of action of central banks.

▪ *Scenario 3*: the adopting for the entire Euro area of the model of the Financial Supervision Authority, respectively the creation of a *mega supervisor of European financial system.* This more effective solution wouldn't assume mergers between European regulating authorities but regrouping within the same field of different entities.

▪ *Scenario 4:* the creation of an *European Bank Commission* whose functioning depends on the institutional relationships with the European Central Bank and the European Commission (and as reality proves it, the solution adopted was the latter).

Although European banking supervision isn't consolidated, however, on an international level the activities carried on by some *Pan European professional organisms and associations,* of which we distinguish:

▪ The European Committee for Banking Standards;

▪ The European Commission for Banking Supervision;

▪ European Payments Council.

The European Committee for Banking Standards is a professional organism which represents the interests of European banks in member states of the European Union. It was created in 1992, through the association of three entities: The European Banking Federation, the European Association of Co-operative Banks, The European Savings Banks Group, with the mission of developing banking standards. Of the three organizations making up the European Committee for Banking Standards, The European Banking Federation stands out, representing the interests of over 4,500 banks from 27 countries and with an asset value of 20 billion Euros, and 2.3 million employees. From the moment of its creation, in 1960, till now, it has constantly maintained the dialogue with European institutions. In 2006 it had 29 members, with an additional 9, among them was Romania (together with Croatia, Monaco, Turkey, Russia, Andorra).

The European Commission for Banking Supervision has as main prerogative: the promotion of convergent supervision practices and the international implementation of the new framework of capital adequacy, as well as the intensifying of cooperation with supervision organisms from other sectors of the European Union and with banking supervision organisms outside the European Union.

European Payments Council has the task to coordinate European banking industry in the payments field. It promoted the creation of SEPA (Single Euro Payments Area), in 2002, to act as an internal unique market, in which citizens and economic players to do transactions easily and without costs.

An important aspect is the fact that in December 2005, *The European Committee has published the document "The Document of financial services for 2005-2010".* The matters discussed in the document revolve around the following points of interests:

▪ The consolidation of progress registered in banking activity and ensuring the effective application of existent rules;

▪ The application of the principles of the "good law" project for all future initiatives;

▪ The reducing of convergence in the field of controlling;

▪ The enhancement of competition between service providers especially on the retail market;

▪ The increase of European influence on financial markets around the world.

With respect to these approaches, the French banks have presented a series of remarks, of which we mention the following:

▪ strategies which refer to retail markets should be active;

▪ fragmentation of banking supervision represents a significant obstacle in the field of European banking market integration, generating distortions in the competition, and the "Document" sets out to provide a real consolidated supervision;

▪ there are no references regarding the competitiveness of European banks as compared to foreign competitors;

▪ the problems regarding the techniques of organizing are totally eluded (for example the application of law from the origin or receiving country, mutual recognition etc.), even if it represents an essential aspect of integration in the unique banking market.

In 2006, the main concerns of the European Commission were:

▪ directives on the consumer credit, through establishing rules in order to eliminate competition distortions between creditors, encouraging trans border activity;

▪ the enforcement of dispositions in the crediting activity, such as: the reducing of the 14 days analysis interval of the file or excluding all non-guaranteed real estate credits from the field of Directive enforcement;

▪ the creation of a *European real estate credit market.* The French Bank Federation has issued the proposal for a European real estate market. Referring to this aspect, it is necessary for the service providers to undergo efforts to propose services outside the national space, in this framework being compulsory to harmonize calculus methods of the annual effective global tax and of its compounding elements, so that there is the possibility of anticipated reimbursements (in the European Union the real estate credit makes up more than 4,000 billion Euros).

On the 1st of December 2005 the European Commission has presented a proposal for *Directive on payment services* within the European market, so that a European payment area would be created. Numerous practices, already existing in France, were taken over and implemented in this directive: the information in advance on tariffs, the irrevocability of payments, the limiting of the responsibilities of card owners, the absence of expenses at the conclusion of the credit contract. The banking concerns regarding this subject have in mind the maintaining of a satisfying security level for the customers and the existence of rules healthy competition between banking entities.

The European banking industry needs a homogenous and stable European juridical framework in order to constitute the SEPA payments means (Single Euro Payment Area). As a consequence, in 2006, banks started to develop informatics systems in order to propose Pan European payment means, for 2008-2010.

Considering that in the process of integrating the European banking sector, an important step was the Basel II Accord, and in the following some fundaments of this important regulation will be presented. It has an impact on the leveling of banking approaches in matters of risk, of which operation risk has an important role.

The impact of Basel II Accord on banking harmonization

The Basel II Accord has a significant impact on the alignment of banking practices in the field of risk management in the European banking system, considering the challenges it has brought in banking activity. The considerable increase in operational risk in the financial-banking industry has brought special concerns at the level of supervision institutions, with the purpose of introducing a discipline which ensures a proper management of this type of risk. Such approaches constitute the content of the document published by Basel Committee in June 2004 "International Convergence of Capital Measurements and Capital Standards". Through this document, the *Basel Committee* intended to fulfill the following *objectives*:

▪ the increase of responsibility level of financial intermediaries through adopting the principle according to: "The degree of freedom of banks is correlated with the quality of risk management and with the efficiency of control";

▪ the development at the level of banking systems of the capacity to adequate the capital through a proper correlation with the actual profile of risk at the level of each institution;

▪ the reducing of the operation risk through the development of a mechanism of capital allocation to a single business unit and by identifying each one's contribution to the risk.

These objectives are realized through the following three directions: the introduction of the specific capital need relevant to the operation risk (1), the reconsidering of the role played by national authorities in the activity of supervising (2) and the use of the market discipline in a more effective way (3).

Through the 3rd direction, the reducing of the operation risk is intended, which from the Basel II Accord point of view can be done using 2 strategies:

a) the creation of methods for the calculus and measurement of operational risk, respectively the minimum capital requirement;

b) the creation of a set of demands and recommendations regarding organizing the activity within the bank.

The Accord also proposes to the bank two alternatives referring to the methods for determining the minimum capital requirement: standard top down methods (the standardized approach and the method of the primary indicator); advanced measurement approaches (AMA). Regarding to the methods proposed, the Basel Committee manifested the tendency to recommend to the banks the use of advanced methods.

The instruments regarding the creation of recommendations in the field of organizing control activities in banks are mainly the development of an internal control system of reporting. Through the set of formulated recommendations, the Basel Committee has intended the development, at the banking institutions level, of management techniques and functional structures specific to the operation risk.

In face of this challenging modifications for the activity of banking institutions, difficulties referring to methods of quantifying the risk have naturally appeared and difficulties regarding the application of activity restructuring rules and procedures. This is the reason why, in the specialty literature, a lot of interrogations were formulated having as main subject the operational risk.

The development of the general framework for measuring and quantification of operation risk needs a systematic effort from banking institutions, regarding collecting data, adopting an analytical framework which would allow the modification of risk data in exposure to operation risk, and the reporting of risk exposures. As institutions compute the minimum capital requirements for themselves on the basis of internal procedures, the necessity for analytical requirements and elements is obvious, in order to fundament the general framework.

For the Romanian banking system, the application of the Basel II Accord represents an undertaking initiated by the monetary authority ever since 2003. Thus, we have Norm no.17 of the National Bank of Romania, which regulates the organizing and the executing of internal audit activity of credit institutions, with the purpose of identifying risk profile, risk level and appropriate strategy. We can also mention Norm no. 5/2004 regarding the managing the capital of credit institutions, through the inclusion of market risk and credit risk in the demand for capital managing.

In the *efforts to implement the provisions of the New Accord in the Romanian banking system,* four stages have been established, as following:

a) the initiation by The National Bank of Romania of dialogue and information exchange in the banking system (May-November 2005);

b) the development of the means to create the supervision of the banking sector according to the standards imposed by Basel II Accord (December 2005- May 2006);

c) the validation by The National Bank of Romania of internal rating models of credit institutions (June-October 2006);

d) the application of the provisions of the Accord in the banking sector (January 2007).

The final objective envisaged through the four stages regarded the qualitative improvement in the quantification methodology of capital requirements provisioned by the Basel II Accord, according to the volume of activity and the risk profile of every credit institution.

As an argument of the impact that Basel II has on the harmonization of practices and laws in the European countries, we can mention the *National Bank's of Romania efforts in the following directions*: the modernization of the legislative and regulation framework in view of the implementation of the new capital requirements (Directives 2000/2/CE and 93/6/CE) comprising the provisions referring to all categories of credit institutions in a single normative act; the development of instruments necessary for prudential supervision of credit institutions; the creation of validation guides of internal rating models of credit institutions; the adopting of the prudential reporting system of credit institutions.

So, as a component of European banking system, the Romanian banking system proves the existence of concerns at the regulating and supervision authority level, in order to harmonize the legislation and in the same time for improving the quality of banking products and services.

At a European level, about the Basel II Accord, it is said that it represents an opportunity without precedent to level the practices of supervision in the European Union (as the president of The European Committee for Banking Supervision, Daniele Nouy says). Through the implementation of the provisions of Basel II Accord in the European banking industry, the principle of proportionality shall be used in the purpose to determine the minimum capital requirements. Modifications in the accounting framework will also take place, and the International Accounting Standards will be adopted for the European supervisors, these requirements creating an opportunity in reaching a regulation and practice convergence, in the context of the new paradigm created by Basel II.

The implementation of Basel II states that the effect will be more ample on the actual credit portfolio, which will determine an important reduction in the need for own funds of large institutions and a significant distortion of competition conditions between the large banks. The main interrogation which was formulated is: if there is the risk of distortion, does it reflect the will of large institutions to obtain a competition advantage through Basel II? In this case, has Europe a reason to follow a way that could waken its banking system, as compared to the large institutions of the USA, which are already players on the world market?

The evolution of smaller size credit institutions in Europe must orientate through multiple actions, in view of avoiding the need of own funds. The large credit institutions in Europe apply complicated computing techniques in order to determine the necessary amount of own funds. Thus, this situates them in the same position as their American counterparts.

A series of interrogations formulated by European bankers at the workshop entitled: "Will small credit Institutes Survive Basel II". We mention the following:

- how are the principles of ethical bank followed through the aims of Basel II?
- how will the depositors of credit cooperatives and Islamic banks, which present more likely the characteristics of mutual funds than banks, will be affected by Basel II provisions?

In face of these challenges brought about by Basel II, the European banking institutions recognize that the convergence of practices and techniques for risk management is needed, in order to handle the new paradigm.

The divergences and interrogations brought about by Basel II Accord were centralized in 2006 by the *European Banking Federation*, which transmitted to the European Commission some points of view regarding the reporting activity and the necessity of discretion in these reports, and also requested that regulations in USA, Switzerland and Japan to be equally considered with the ones in Europe. Of the subjects found in the Document transmitted by the European Banking Federation, the following stand out:

- in case the risk and capital are managed in a centralized manner, at the banking group level, than the current limitations must not be applied to the exposure within the consolidated group;
- the credit derivatives must be supervised on the basis of rules which the European Commission is to create.

As an answer, the European Commission has transmitted to the European Committee for Banking Supervision a series of information about actual practices and analysis techniques of risk, establishing as a term for applying the Basel II provisions the end of 2007.

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