



Deutsche Bank Position Paper on EU Banking Supervision

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Towards full Integration of EU Banking Supervision

Using the momentum – creating the integrated supervisory regime necessary for an integrated market

Crises can help necessary change to happen. Change of the current EU system of banking supervision is necessary, and the pending financial market crisis provides the momentum and the political impulse to act.

The case for full integration of EU banking supervision is compelling. The 46 largest EU banking groups hold 68% of all EU banking assets - and their share is rising. These pan-European groups have developed group-wide integrated and centralised ways of doing business and managing risk. In an integrated EU market they rely upon increasingly integrated infrastructures. Pan-European banking groups and the cross-border infrastructure for their businesses play a pivotal role for EU financial stability. Which begs the question: Can today's scattered landscape of European banking supervision rise to the challenge? Deutsche Bank believes it cannot, and despite the efforts over recent years the gap between the EU's increasingly integrated financial market and its nation-based supervisory system is at risk of widening further.

The industry expects more and, we believe, is entitled to higher expectations. Policy-makers over many years have been calling upon the private sector to embrace and drive the process towards EU financial market integration. The industry has done so. It has struggled and continues to struggle with the bureaucratic complexities of now 27 harmonised, but still distinct, national supervisory regimes, many of them with 2 or more regulators. The duplication of internal systems and processes for group-wide risk management and for local regulatory and reporting requirements creates significant costs and potentially additional risks. It is time for the public sector, for regulators and the European legislators, to respond to the new realities they have been pushing for. The integration of banking supervision in the EU is a necessity. It has to come and we have to shape it now. The pending review of the CRD (and the finalisation of Solvency II) opens a window for necessary change and we cannot afford to wait until the next crisis hits.

Institutional integration – a European System of Financial Supervision

Full **institutional integration** is an enormous challenge. Yet, it is not the first time that the EU is embarking on a vast change project and the model to draw on is obvious. As national EU central banks have become an integral part of the ESCB so national supervisors will have to become part of a **European System of Financial Supervision** (ESFS). Such a system would comprise a new EU-level institution responsible for the supervision of the systemically relevant banking groups that operate on a pan-European basis. The ESFS would have to work closely with the ESCB, not least in order to ensure joint central bank and supervisory action necessary to respond effectively to a crisis situation. Institutional integration of financial supervision would provide the much needed governance for group-wide, cross-border supervision and would ensure that all national authorities have their say in a centralised but federal system. At the same time it would give the EU the clout to finally punch its weight in international regulation.

What we need at this stage is a plan, a blueprint and roadmap for radical long-term reform to achieve full institutional integration. This blueprint has to address more than just the architecture of a European

integrated system of banking supervision. Other aspects are as important: a single rulebook for banking supervision, a deposit guarantee scheme that is commensurate with an integrated financial and supervisory system, and a common insolvency regime are all necessary elements of full integration. The work on the blueprint and roadmap has to be launched now. We need a map to ensure that the next steps are not taking us in the wrong direction. Deutsche Bank believes that a group of wise men bringing together the different stakeholders should be set up and tasked to develop this blueprint and roadmap.

Operational integration – colleges of supervisors

Institutional integration will not happen now or tomorrow. It will take time and efforts to overcome the many obstacles. However, the pressing needs of the European integrated market cannot wait. As an immediate response to these needs and as a first step towards institutional integration full **operational integration** of the supervision of systemically relevant pan-European banking groups must be achieved now. In line with the most welcome ECOFIN conclusions of May 2008, Deutsche Bank believes that three basic elements are fundamental for operational and eventually institutional integration of pan-European group-wide supervision:

- **Colleges of supervisors with the consolidating supervisor as process leader,**
- **A centralised governance based upon a strengthened CEBS, and**
- **Adequate resources, expertise and group-wide supervisory tools**

Colleges of supervisors under the **lead of the consolidating supervisor** are the plinth of supervisory integration and we welcome the Commission proposal to anchor supervisory colleges in the CRD. However, legislative measures and the proposed improvements of the regulatory framework for information exchange, coordination, and cooperation between consolidating and host supervisors are not enough. Supervisors must be committed to make colleges work, to change their supervisory practices and processes accordingly and move towards a common, integrated supervisory culture.

- Full operational integration of group-wide day-to-day supervision requires **strong lead**. The consolidating supervisor must be more than the 'primus inter pares'. Assigning to it – in addition to the pillar 1 model approval – the task of **coordinating and planning all group-wide pillar 2 supervisory activities** is necessary and the Commission proposals in this regard are welcome. But they are not going far enough. The consolidating supervisor must have the authority necessary to live up to his task. If host supervisors retain the decision-making power over group subsidiaries operating in their jurisdiction, the consolidating supervisor must be vested with the group-wide authority "to determine whether the arrangements, strategies, processes and mechanisms implemented by the credit institutions and the own funds held by these ensure a sound management and coverage of their risks" (Article 124 (3) of the CRD). This ultimate outcome of the group-wide pillar 2 "Supervisory Review and Evaluation Process" and its annual update (required by Article 124 (4) of the CRD) not only summarises the fact finding and analysis resulting from past pillar 2 off-site and on-site supervisory work, but also informs the supervisory activities over the next supervisory cycle. In order for **the consolidating supervisor** to be able to coordinate and plan the college's supervisory activities for the next cycle, it **must have the final say** where consensus within the college cannot be achieved. The consolidating supervisor must be the **process leader** and must drive on the basis of the documented annual supervisory review and evaluation the supervisory activities of the college for the entire banking group.
- Process leadership requires that communication between the college of supervisors and the supervised banking group must be channelled through the consolidating supervisor. It has to be the **central point of contact** for the banking group. More importantly, it must be for the consolidating supervisor to sign the "Dear CEO"-letter communicating to the banking group and for all its subsidiaries the strengths and weaknesses the college has identified throughout the supervisory cycle and any remedial action the college considers necessary.

- Full operational integration of day-to-day group-wide supervision requires more than bi-annual meetings of senior members of the college. Colleges must operate as **virtual teams** cutting across the participating supervisory authorities. **Delegation of tasks and responsibilities** within this team is necessary. It requires appropriate legal grounds and ultimately cost-sharing arrangements. However, delegation has to be embedded in ongoing **joint work** involving all relevant line side supervisors and **joint teams of technical experts**.
- The proverbial truth that too many cooks spoil the broth also applies to colleges. Cooperation and joint work is possible only within a team of appropriate composition and size. For effective and efficient, risk-based supervision of a banking group the college composition must mirror the risk-profile of the group. In many cases the setting up of a **core college** is warranted. This core college should only comprise the consolidating supervisor and those host supervisors responsible for operations and businesses of the group that, from a risk-perspective, are significant. That said, we acknowledge that host supervisors of branches with systemic significance for the host market have a role to play. At the same time, important non-EU operations of a banking group that contribute significantly to its risk-profile cannot be ignored for risk-based supervision of the group. The competent **non-EU host supervisors** have to be included in the college.

Operational integration under strong process leadership of the Consolidating Supervisor needs effective **centralised governance** to ensure **convergence and consistency across colleges**. Only an appropriately **strengthened CEBS** can provide this governance framework.

- Specific **CEBS' guidance on the operational functioning of colleges** is a key element of centralised governance and essential to ensure convergence of supervision across colleges. The group-wide pillar 2 supervisory review and evaluation process of all colleges must follow the **same methodological approach** in order to generate **consistent outcomes**. The CEBS' template for written agreements on the cooperation between consolidating and host supervisors was a first step in the right direction. But more specific guidance on the process and the underlying methodology for the pillar 2 supervisory review and evaluation is needed to ensure a level playing field. The considerable diversity of the methodologies and processes national regulators have developed over recent years is unwarranted and runs counter the convergence objective. It reflects the still significant differences in supervisory culture and philosophy. Operational and, eventually, institutional integration has to overcome these differences. Like banks, supervisors have to develop and implement best supervisory practices and it is CEBS' role to provide the necessary guidance.
- This additional CEBS' guidance must be ambitious and sufficiently specific to achieve the convergence objective and deliver integrated group-wide supervision. To this end the CEBS has to be strengthened. **Qualitative-majority voting** combined with a **'comply or explain'** principle is necessary to ensure that guidelines on college processes and the methodological approach to the pillar 2 group-wide supervisory review and evaluation (and any other issues) are more than the smallest common denominator the current consensus-based decision-making generates.
- As part of the centralised governance, enhanced monitoring and – helped by peer pressure – “enforcement” of the CEBS' guidance is needed. In order to ensure that the more ambitious guidance on college processes is implemented across all supervisory colleges a **panel review process** for operational integration should be established. This review process should cover at a minimum the colleges for the most important pan-European banking groups. Ideally the review panel should be set up as a joint group of senior members of the **CEBS** and the **ESCB's Banking Supervision Committee**. Bringing in the central bank perspective is crucial to ensure college processes that facilitate ongoing close cooperation between supervisors and central banks not least to prepare for, and effectively manage crisis situations. In line with the required annual update of each group-wide supervisory review and evaluation the panel process should follow an annual frequency. For each college the responsible consolidating supervisor, assisted as appropriate by the host supervisors participating in the college, would present the supervisory activities of the college, the resulting review and evaluation of the banking group and the planning

of supervisory activities for the coming cycle. This "**beauty contest**" would promote both, convergence and continued sophistication and innovation of group-wide risk-based supervision. The review process would greatly benefit from inviting the banking group concerned to present its experiences with the supervisory activities of the college.

- The necessary strengthening of the CEBS also requires **adequate resources** and **funding**. CEBS must be appropriately staffed for the much stronger, central lead it has to provide. Consideration should also be given to compensation for the CEBS' chair. It has to be acknowledged that leading the CEBS requires 100% attention. Adequate compensation would also contribute to a more independent and "European" approach to the chair's tasks and is a prerequisite for stronger European accountability of the CEBS.

Operational and eventually institutional integration needs adequate **resources, expertise** and **supervisory tools** that can be applied at a **group-wide level**.

- Significant gains in efficiency and effectiveness of cross-border, group-wide supervision can be expected from full integration. However, these gains come at a price – a moderate price, which will decrease, the more integrated the group-wide supervision becomes. **Adequate resources and expertise** are a prerequisite for the supervision of the highly knowledge-based and innovative businesses of pan-European banking groups. In particular the continuous training of supervisors is essential to deliver consistent, high-quality supervision across the businesses, market places, jurisdictions and languages pan-European banking groups cover. For this training of, eventually, a new generation of supervisors we need one school, not 27, and the focus must be on the business practices of the pan-European banking groups. There is no better place to learn about business practices than the inside of these groups. Internships must be an integral element of supervisory training. The necessary efforts are significant. All stakeholders must be prepared to contribute.
- Finally, operational and institutional integration needs **tools for group-wide supervisory action**. At present only Article 129 (2) affords the consolidating supervisor with decision-making powers at group level. However, such centralised decisions are limited to the pillar 1 model approval process if after 6 months no consensus has been achieved between the consolidating and the host supervisors. More importantly, the consolidating supervisor's decision is not directly binding for the host entities belonging to the group. The decision still has to be translated by the host supervisor into a national administrative act that is legally binding for the host subsidiary under the host jurisdiction. For the necessary integration of supervision that is not good enough. Integrated supervision requires a **European administrative act** that can be issued by the consolidating supervisor with direct legally binding effect for legal entities in host countries. Without such a tool group-wide integrated supervision remains a toothless tiger exposed to the complexities and the legal risks of a multi-jurisdictional regime and to a cumbersome CEBS mediation process whenever consensus cannot be achieved within the college.

Deutsche Bank is convinced that significant progress towards the integration of supervision of pan-European banking groups can and must be achieved. Based upon the conclusions of the May ECOFIN and with the momentum of the pending crisis the review of the CRD offers a unique opportunity for necessary change. Operational integration as immediate response to the needs of the increasingly integrated EU financial market has to be realized now. At the same time we must not lose sight of the ultimate objective. Deutsche Bank calls for the establishment of a group of wise men tasked to elaborate a blueprint and roadmap for the future of institutional integration.

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