

EPFSF Lunch Discussion

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“Financial supervisory architecture”

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Distinguished Members of the European Parliament,
Ladies and Gentlemen,

I am very pleased and honored to have been invited here today to comment on the future of Financial Supervision in Europe. I particularly appreciate the opportunity to share with you some thoughts and concerns on the matter from the perspective of a risk manager, responsible of this area at Intesa Sanpaolo, one of the largest European banking groups, leader in the Italian banking system, with a sizeable international presence, in particular in Central and Eastern Europe¹.

The recent financial crisis has revealed the vulnerabilities of the international financial system. In order to restore an enduring confidence in financial markets, political and regulatory authorities are working on many topics, following two main streams:

- **a substantial overhaul of the supervisory framework**, aimed at effectively facing the rising sophistication and cross-border integration of modern financial systems;
- the **increase of minimum capital levels** beyond current Basel II requirements, accompanied by the determination to **solve the issue of pro-cyclicality** that characterizes the current capital adequacy framework

My intervention will mainly concentrate on the first issue, however I will also spend few minutes to share with you some comments concerning pro-cyclicality that are outside the scope of the Financial Supervisory Architecture debate, but nevertheless of crucial importance – probably in my view one of the main problems - to address the financial stability issue.

The legislative proposals presented by the European Commission on the 23rd September, shaped upon the De Larosière report, are an important step towards a more effective supervision in the EU; we appreciate the Commission’s efforts to promote the European single market in financial services and we believe that the great value of the recently proposed improvements is the recognition of the need to

¹ Key figures of Intesa Sanpaolo in Italy are a market share of approximately 18% in customer loans and deposits in Italy, approximately 11 million clients and a domestic network that accounts for more than 6,000 branches. Its international presence is largely represented by:

- a selected retail banking presence in Central and Eastern Europe and in the Mediterranean Basin reaching more than 8 million clients in 13 countries through roughly 1,900 branches;
- an international network with a presence in 34 countries to support cross- border activities of corporate customers.

set common supervisory rules at the European level, as a prerequisite to conduct an efficient and effective supervision of markets, institutions and instruments, both at micro and macro level.

The success of the reform of Supervisory Architecture will depend from the (re)resolution of some critical issues, which can be summarized as follows:

- The **creation of the European Systemic Risk Board (ESRB)** will be a crucial development. It is now clear that the risks faced by the banking system as a whole differ from those faced by individual banks. The recent crisis demonstrated that a sum of well capitalized banks could not result *per se* a robust and stable banking system. Therefore a body responsible for the “macro-prudential” supervision is needed. Anyway, important factors of success will be:
 - the effectiveness of **adequate analytical capabilities** and access to supervisory information;
 - ESRB will not have to focus only on macro-economic analysis, but it will have to translate analysis into action through **effective policy tools**; in this area, those macro-prudential tools aimed at **reducing the procyclicality** of regulations (or, ideally, aimed at making them counter-cyclical) will be of the utmost importance; I will come back later on this issue.
- With regard to **micro-supervision** the EU policymakers have chosen to maintain supervisory regimes where the authorities are local instead of unified entities; this approach has the important advantage of being pragmatic and “evolutionary” and able to build on the experience of the Lamfalussy architecture; the drawback of this choice is that it will result in a complex three-layered framework for micro-prudential supervision - the **European System of Financial Supervisors – ESFS** - composed, at the bottom layer, of a large and very heterogeneous group of national supervisory architectures (47 agencies for 27 countries). This choice implies the coordination of a wide variety of governance arrangements, supervisory cultures and regulatory frameworks. Moreover, since the architecture proposed by the European Commission also establishes a sector-specific system at the supranational level (**EBA, EIOPA, ESA**), inter-agency coordination issues could arise from this unsolved heterogeneity. As a consequence, the proposed approach will have to face the following main challenges:
 - First of all, the establishment by ESFS of the single rule book; establishing common rules will turn in a success only if the interpretation by the national supervisors will be the same.
 - Supervisory practises among EU countries; the reform does not explicitly address the issue of their heterogeneity. We think that also practices should be subject to the “*comply or explain*” mechanism.
 - Centrality of Colleges of Supervisors; the new EU supervisory system proposed by the European Commission is based on the enforcement of these entities, that play a very important role in its design, ensuring a balanced flow of information between home and host authorities; however, it should be noticed that there is a significant gap between “as is” and “to be” situation.

As a final comment on the reform of Financial Supervision architecture, we know that convergence needs time and cannot be achieved without a gradual process that

leads to the creation, and the subsequent empowerment, of appropriate bodies: “*Natura non facit saltus*”. The coordination of the European System of Financial Supervisors is a pragmatic way forward; however we believe that in the medium term the reform of the EU supervisory architecture should further pursue the objective of a supervision of cross-border groups at central level, in order to strengthen EU financial stability and permit a significant benefit for financial institutions, markets, and consumers. The main difficulties arise from the lack of definition of agreed mechanisms at EU level on crisis management, resolution and relative fiscal burden sharing which have to be put in agenda for a pragmatic solution in the near future.

I would like to conclude my speech by briefly examining the different measures currently proposed by regulators to reduce the pro-cyclicality of Basel 2 capital requirements:

- countercyclical capital buffer;
- dynamic provisioning.

As already mentioned, the ESRB should play a central role in implementing these measures, therefore they have a strong link with the current debate around the supervisory architecture.

Starting from the countercyclical capital buffer, the Basel Committee on Banking Supervision recently stated its intention to introduce a new regulatory measure aimed at forcing credit institutions to build capital cushions (above the minimum required level) during economic growth, that can be released during recessions.

We believe this could be a good idea: in some way, it means reverting the attitude used so far, also during the current crisis, to react to economic downturns and asset quality deterioration by **increasing the level of capital protection**, thus causing a **sharpening in credit crunch**, a deepening in real economy crisis and asset deterioration and so on. It is self evident that such a vicious circle can easily produce exactly the reverse of what the regulation is designed for, namely financial instability and systemic risk.

In this respect, recognising the concept of a countercyclical role of capital, the proposal seems to be a significant step forward. It is consistent with the conceptual meaning of capital used as a weapon against unexpected losses to be **built up in time of peace and used when the war is on, and not vice versa as it happens today**.

As usual, however, the devil is in the details, namely in the mechanism according to which the capital buffer should be implemented. There are several alternatives under discussion at BCBS and CEBS: all of them are based on automatic triggers linked to macro- or firm specific variables.

We believe that none of these alternatives assures the necessary flexibility and we are afraid that imposing a too automatic solution entails for the European banking system the risk of being charged with capital requirements that are “frozen” at the top of the current crisis. Instead of creating automatic links between capital buffer and

predefined parameters, a better solution would be that of calibrating it according to an experienced assessment of the macroeconomic framework.

The issue of countercyclicality is too important to be delegated to a simple set of “mechanical” rules. It needs the intelligence and, let me say, the common sense of a competent and authoritative institution, and here I come back to the issue of supervisory architecture: the **European Systemic Risk Board is in our opinion the body which should be assigned to such an important task.**

The second measure currently being studied with the aim of mitigating procyclicality is a **reform of the accounting treatment of impairment** based on more forward looking provisions referred to expected losses, rather than to the concept of incurred losses currently adopted by **IAS 39**.

The idea is simple and very similar to the concepts I mentioned some minutes ago talking about the need of “building weapons in time of peace to be used when the war is on”. Please note that, once again, this is exactly the contrary of what happens now, with provisions based on incurred losses following a sharp pro-cyclical pattern. It can be achieved by a system of dynamic provisioning, like the one which is in place in Spain since the early 2000s and, looking at publicly available data of the largest Spanish banks, it seems to have worked well during the current crisis, helping to smooth the impact of credit losses on earnings and, consequently, on capital.

Unfortunately, however, this does not seem to be the direction towards which the competent institutions are currently going. The **IAS Board** has recently brought out a **proposal** based on an expected loss concept, which seems **unable to reduce procyclicality in provisioning**. The European Commission, on the other hand, is elaborating a proposal more consistent with the objectives of dynamic provisioning, but envisages to introduce it on top of accounting provisions as defined by the reformed IAS, with a clear risk of creating double tracks and inconsistencies between accounting and regulatory rules.

Once more, we come back to a problem of institutional architecture, which in this case can involve also the creation of uneven playing fields between Europe and the rest of the world.

Our obvious recommendation is that all international institutions entitled with designing the new financial architecture work closely together and that impact and spill-over effects of the whole set of new rules be carefully assessed before implementation.

I thank you very much for your attention. I will be glad to answer to any comments or questions you may have.