EBCI Vienna Initiative

Observations on Cross-border Supervisory Practices

October 18, 2012

Introduction

Over the last few years, representatives of the Vienna 2 Steering Committee have been involved in extensive discussions relating to cross-border supervisory practices.[1] The Committee has been able to observe the gaps between the principles as set out in law and their practical implementation. They have had the opportunity to see how relations between supervisors in home and host countries have actually developed in practice. Frequent contacts with national authorities and with the private banking sector have added further insights.[2]

Following up on this experience is a part of the work of the Vienna 2 Initiative. The Vienna 2 Steering Group has undertaken to compile in a note a number of observations relating to the practical application of cross-border supervision. These observations and associated suggestions, generally seen from the view of host countries, but also from a wider European perspective, may add to other lessons from the crisis. In this way they may provide the European Commission, the EBA, the ESRB and the ECB with input as they develop supervisory structures further and harmonize supervisory practices.

The twenty-two observations below reflect what experts, mainly from the IFIs, have seen of supervisory cooperation in practice over the last few years. They were discussed in a workshop in London on September 12, 2012 hosted by the EBRD, with participants from home and host country supervisors, central banks and fiscal authorities as well as participants from key parent banks. The outcome of the discussion is reflected in this note.

By way of background, it should be noted that the EBA and the supervisory colleges have made important strides over the past two years, in particular during the stress test and the recapitalisation process ending in June 2012. Plans and measures have been discussed in the colleges even where clear conflicts of interest have been present. The EBA has intervened, formally and informally, and earned respect in a way that has not been previously seen. Developments clearly have gone some way toward mitigating several of the concerns expressed in the observations below. The Commission's Proposal on Bank Recovery and Resolution and the Proposal on a Banking Union also

[1] The EBRD, EIB, IMF, World Bank, and European Commission are members of the Steering Committee as well as Italy and Romania, which represent home and host authorities respectively. The Committee is chaired by Marek Belka, President of the National Bank of Poland.

[2] The European Commission may have different views on the issues addressed in this document.

address some of the issues raised in the observations. At the same time, the proposals raise new questions. Many issues related to the gaps between legal structures and their actual implementation remain valid or may even have become more acute.

A general problem in the focus of the Vienna 2 Initiative is the fragmentation of European banking. Retrenchment into national borders (ring-fencing measures and substantial cutbacks in cross border activities) carry high economic costs and risk, straining the relations between home and host authorities, especially in emerging Europe, where foreign banks typically dominate local banking systems.

Twenty-two observations

General issues

1. **Externalities beyond colleges.** The supervisory colleges, each focusing on a separate cross-border banking group and consisting of national supervisors, will quite naturally have a perspective confined to their mandate. But the crisis has shown that external effects may be large and that actions from supervisory colleges may have important effects on banks and countries outside their remit. A wider perspective will sometimes be necessary, covering the EU as a whole and at times also the non-EU countries of emerging Europe. Bringing this wider perspective into the colleges is important, as clearly recognized in the CRD IV. But implementing a wider perspective may be hampered by natural conflicts of interest, resulting from different perspectives and division of responsibilities between home and host supervisors, some of whom are not even represented in the colleges. Can such conflicts be handled by the EBA, supported by the Commission and by the ESRB, within the present (and suggested) legal framework?

   Important conflicts of interest remain to be addressed if colleges are to take a wider European perspective, as indeed they should according to CRD IV.

2. **More fiscal authority involvement.** In some supervisory colleges, discussions on supervision seem to have been hampered by disagreement on crisis management and resolution for which responsibilities are unclear and not fully congruent with supervisory responsibilities. As supervisors are not tasked with solving resolution issues that may involve emergency liquidity support and capital support risking taxpayers' money, ministries of finance must be brought into the discussion. Central banks should also be part of the discussions, providing when appropriate liquidity support against adequate collateral. To some extent this can be done within the "variable geometry" of colleges, provided that confidentiality problems can be overcome. But hitherto such participation has not proven very successful. The Cross Border Stability Groups (CBSGs), or the Crisis Management Groups (CMGs), where central banks and ministries of finance should have seats, were designed to complement the supervis*ory* colleges in this respect. But, so far, the involvement of ministries in CBSGs and CMGs has been confined to a limited number of cases. Resolution colleges may be a way to partly address the problem, given that fiscal authorities are invited to participate.

In matters relating to resolution, involvement of fiscal authorities and central banks is essential for supervision to work properly.

The working of colleges

3. **Senior level engagement by both home and host authorities**. Concerning who should participate, the supervisory colleges appear to work much better when representatives from both home and host authorities are at a sufficiently senior level – at least at some meetings - to ensure an informed policy discussion and to make required decisions possible. This is indeed what is stipulated in the EBA guidelines. To the extent that line supervisors participate, they may not always have been empowered to take necessary decisions.

4. **Building trust through better preparation, organisation and governance.** As indeed true for all groups that work with difficult issues, mutual trust between members is important in a supervisory college. Human elements play an important role and building relations is an important part of the work. A prerequisite for trust is that information is provided in advance to members on equal terms, so that all parties can prepare properly for upcoming discussions. A good practice is to have an agenda circulated and adopted in advance. Also, some members in a college have been tardy with providing promised data, which hampers the information process and the work of the college.

5. **Enhanced coordination between college meetings.** Domestic authorities do a lot of work between the meetings of the supervisory colleges. Indeed, colleges are a means of on-going multilateral cooperation. For a continuous two-way flow of information to function in practice between meetings, some kind of agreement, e.g., a MoU, seems to have worked in a number of cases. This helps the participants to explain their need for information in advance and works to avoid misunderstandings and frustration.

6. **Pre-arrangements ("prenuptials") of home and host authorities for new cross-border activities.** Colleges are supervisory, not licensing, bodies and the CRD IV sets clear rules for the establishment of branches and subsidiaries in host countries. However, when a banking group is to be established in a host country (whether branch or subsidiary), the supervisory cooperation is improved if the conditions for establishment and for the conduct of supervision are first discussed and agreed by home and host supervisors in cooperation. If there is a supervisory college established for the banking group, the college may have a role to play.

7. **Better coordination of stress testing**. Stress tests are important supervisory tools and there are many different kinds of stress tests with different purposes. Some stress tests may, when their results are published, influence the behaviour of banks and financial markets, both at home and abroad. In the past, cross-border aspects of stress tests seem to have been neglected or underestimated. For instance, the EBA used to publish the results for the whole banking group, not showing the results of the subsidiaries. Furthermore, host supervisors would not receive information on the situation of parent company on a stand-alone basis. Awareness

of these problems seems to have increased over the last two years, however. Publishing stress tests results on a decentralised level, not only for the group but also for the subsidiaries separately, could be considered, and any differences between home or EBA and host stress test results for the same subsidiary needs to be reconciled before publication.

8. **Core vs. full colleges in the emerging European context.** Supervisory colleges often have two configurations, full colleges and core colleges. But there is a concern about how this split is done in practice and who gets included in the core - and under what conditions. Information flows between the two configurations are regulated by the EBA guidelines. Still there is a concern that the inner group has access to relevant information also needed by the full college. These concerns can be particularly acute in the case of smaller countries which are not systemic for the (home) banking group but highly so for the host.

   Even if EBA guidelines cover most of the issues above, problems clearly remain in getting the guidelines being observed and implemented in practice. An annual, confidential survey on the working of the colleges, divided by constituency, may be a way to increase trust. Preferably, better use could be made of existing peer review interviews and surveys conducted respectively by the EBA and by the BCBS through improvements along these lines.

The role of the EBA

9. **Senior EBA presence in colleges.** The supervisory colleges, where host countries have participated, have worked at their best when the EBA has been represented at a reasonably senior level – which again is according to the EBA guidelines. Where this has been the case, tendencies to neglect the voice of the host countries have been less pronounced and there has been – in principle - a possibility to mediate in case of disagreement between home and host authorities. Furthermore, there seems to be an important role for the EBA to ensure that difficult or controversial questions are brought up for discussion in colleges.

   More open and active discussions in colleges should be encouraged and senior EBA presence would support this.

10. **The credibility of the EBA as a mediator.** The mediation role of EBA does not seem to be clear and accepted by everyone in spite of the adopted and approved mediation procedure. There are issues relating to whether the EBA can be regarded as an honest broker and there are concerns related to whether the EBA has sufficient knowledge and understanding of local circumstances to solve disagreements adequately.

    Of course, the EBA cannot proactively assume a mediation role – a college member has to ask for it. So far, the role of the EBA as a formal mediator has been close to non-existent. But in a number of cases the EBA has had an important role as an informal rather than a formal mediator. Given the circumstances, this may have been the only way forward.

And, as pointed out before, the EBA cannot work as a mediator when fiscal issues (tax-payers' money) are involved and should not be expected to do so.

The credibility of the EBA as an "honest broker" must be improved, including through enhanced transparency. Furthermore, there must be an agency/unit involving fiscal authorities named to act as a mediator when fiscal issues are relevant.

Non-EU countries

11. **The case of non-EU countries where cross-border banks have systemic presence.** There are some non-EU countries that host domestically systemic subsidiaries of EU banks. These countries do not participate in the supervisory colleges (unless invited), which may create problems, both for the non-EU countries and for the countries represented in the supervisory colleges. The forum for communication, discussion and conflict handling provided by the supervisory college is simply missing.

    A particular problem appears with non-EU countries, where the legal supervisory frameworks are considered to be weak in terms of confidentiality. Furthermore, some non-EU host countries have had difficulties to deliver necessary information to the college.

    Bringing the relevant non-EU countries into the cooperation by special agreements or MoUs (lacking legally binding agreements) may be a way forward that is of interest to all parties. When necessary, EBA guidelines should be developed to handle the cooperation with the non-EU countries.

12. **The role of sub-regional arrangements**. The countries of emerging Europe are different in many respects, but they also have a lot in common, for instance in the financial sector, where banks tend to have similar structures, concentrating on traditional consumer and SME. In the Nordic-Baltic region, the authorities have decided to develop the cooperation through a regional Cross Border Stability Group (CBSG). To a large extent, this is a way to build and maintain trust between all stakeholders: supervisory, central banking and fiscal authorities.

    The possibility of increased sub-regional cooperation between home and host countries in emerging Europe should be investigated, particularly for non-EU countries.

Issues relating to crisis management

13. **Information in stressed situations.** Supervisory colleges are not the place where financial crisis should be managed. But they have a role to play also in stressed situations, and these are difficult to handle in supervisory colleges as in many other committees or working groups. Also, conflicts of interest surface often most clearly

in stressed situations. Colleges seem to work more efficiently when having communication plans that are tested in advance and having agreed procedures how to notify other representatives, either home or host, of any adverse material developments. Informing before acting is also a prerequisite for maintaining trust and confidence.

14. **RRPs' approval for systemic banks by both home and host authorities.** According to the Directive on resolution, Recovery and Resolution plans (RRPs) will become important tools in cross-border supervision and resolution of banks. But there are conflicts of interest, where for instance a parent bank and home supervisor may have incentives not to show or set up the recovery plans together with the host supervisors. But RRPs gain in credibility if they are discussed and approved by all countries where the relevant bank plays a systemic role. Possible conflicts between home and host authorities may be brought to the surface in such discussions, which would help the EBA to mediate if invited to do so.

    It may be that the present conflicts of interest relating to the deleveraging of bank assets could have been mitigated if they had been discussed in an RRP context and with the EBA playing a more significant role. This issue is actually covered by Ecofin decision, but the implementation has been questioned. The EBA recent capital exercise may have provided some positive experience.

15. **Systemic local presence of cross-border banks.** The existence of systemic branches was not really envisaged when the EU legislation was written. In the CRD IV the possibility of systemic branches is recognized and host supervisors of such branches are members of the supervisory colleges. However, home country supervisors are still responsible for the supervision of branches. Leaving a host country with little or no supervisory power over important parts of its financial system while expecting it participate in the reconstruction of a bank, possibly using taxpayers' money in the event of crisis is clearly undesirable. This is true not only for branches, but also for subsidiaries. How this can be arranged is, at least at present, up to the countries to decide. In this respect, a non-binding MoU may be better than nothing. The Nordic-Baltic MoU, for instance, states that a host country will participate in the resolution of a bank only to the extent that it has gained influence over its supervision in normal times, prior to the crisis. To what extent this will work in practice remains to be seen. However, it is no doubt in line with the relevant recommendations in the MoU of 2008.

16. **Supervisory cooperation in stressed times.** In stressed situations, host countries may feel the need to restrict the operations of bank subsidiaries under their jurisdiction, particularly if these subsidiaries are of systemic importance. The practical tools in crisis management, such as limiting dividend payments, requiring more capital (locally or by parent), raising liquidity requirements etc. seem to work much better if decided and applied in cooperation between home and host supervisors. Preferably, there should be support from all parties for measures considered necessary to protect financial stability.

17. **Cross-border spillovers from regulatory/supervisory actions.** In crisis situations, capital or liquidity or both are usually in short supply – or thought to be

so by domestic supervisors, whether home or host. A natural reaction is to try to protect domestic deposit holders by keeping capital and liquidity at home – that is to ring-fence. This reaction has been observed in many EU countries over the last few years. But ring-fencing is rarely optimal for the common interest and may in the end, if the situation for the ring-fenced bank gets worse, hit back on the ring-fencing country.

In a crisis, issues of communication get even more important than in normal times. Crisis communication must be discussed and agreed upon beforehand in supervisory colleges. The use of tools in crisis management and resolution should also be discussed in the supervisory college. Or perhaps within the CMGs or the CBSGs or the resolution colleges, since the problems may ultimately relate to resolution and burden sharing. If a host country is to be expected to participate in the possible resolution of a bank in crisis, it must get a corresponding say in its supervision in normal times.

The Banking Union[3]

18. **The proposed banking union for the Eurozone has important implications for emerging Europe.** Efforts to achieve genuine Economic and Monetary Union (EMU) have gathered momentum with the June 2012 euro area summit and the September 2012 EU Commission's subsequent proposal for the establishment of a Single Supervisory Mechanism (SSM), which could pave the way for direct bank recapitalization by the ESM, and the communication regarding a Roadmap towards a Banking Union. While these proposals and further steps necessary to complete EMU are still under debate, important elements of the banking union, such as the SSM, the single rule book, and harmonized recovery and resolution regimes, are scheduled to be finalized by end-2012.

    The plan to establish a banking union is welcome as a key step towards resolving the Eurozone crisis and improving supervisory policies and practices, with a positive impact on Emerging Europe with its close financial and economic ties to the Eurozone. However, it also gives rise to a number of questions for the region. Can the banking union be leveraged to overcome the home-host coordination problems described in this note? Under what conditions would it be advantageous for EU-countries in emerging Europe that do not currently use the euro to join the banking union? How can it be ensured that the interests of smaller host countries outside the banking union will be duly taken into account?

19. **Ensuring that the benefits from the banking union for non-Eurozone countries that decide to join the SSM are commensurate with those for Eurozone members.** Exercising the proposed option to voluntarily joining the banking union ("entering into a close cooperation with the ECB") may be in principle a proposal worth considering as more centralized supervision could short-circuit some of the very home-host coordination problems that are the subject of this note. However, the countries of emerging Europe cannot be expected to relinquish their supervisory responsibilities without assurances that they have

[3] The implications of the proposed banking union for bank resolution will be taken up in a parallel paper on bank resolution issues in emerging Europe that the Vienna 2 Initiative is preparing.

appropriate voice in shaping centralized supervisory decisions. Practical arrangements that allow the centralized supervisor to make the best possible use of local expertise are also important. Furthermore, the benefits of common supervisory control would be much enhanced if supplemented by participation in common backstops as well. In general, all efforts should be made to confer benefits of the banking union for the non-Eurozone countries that join the SSM commensurate with those that will become available to Eurozone members. This would maximize the take-up of the opt-in clause and reduce the risk of regulatory and supervisory arbitrage that could potentially damage the integrity of the single market.

20. **Dealing with the concerns of hosts outside the banking union.** Inevitably, some host countries will remain outside the banking union, either because they are not EU-members or because entry conditions and their particular economic circumstances argue on balance against opting in. The mandate of the centralized supervisor and the procedures within supervisory colleges and EBA should be designed or revisited with a view to ensuring effective coordination with hosts and a meaningful participation by them in the decision-making process.

Other issues

21. **Macro-prudential instruments.** The importance of macro-prudential measures is increasingly recognised for ensuring financial stability and avoiding boom-bust cycles. Countercyclical capital buffers and ceilings on loan-to-value ratios are prominent examples. Restrictions on bank lending in foreign currency and restrictions on bank borrowing short in dollars are other measures recently discussed. The ESRB and the BIS lead the discussion in this area.

    The *macro-prudential perspective should be brought into the discussions in the supervisory colleges, not least since a number of them have substantial cross-border dimensions.*

22. **Understanding the full effects of regulation.** The new regulatory environment, notably Basel III, CRD IV, Solvency II and the FSB work on SIFIs, is a natural part of discussions among competent authorities. However, even though the effects of any given regulation may be reasonably well understood it is, at present, very difficult to judge the combined effect on any given bank and on the financial system as a whole. Furthermore, applying the regulations in one country (home) may have substantial effects in other countries (hosts), or vice versa.

    The issues of combined regulatory effects are already recognised as important in supervision, but will require further attention in colleges.