Tom de Swaan

The Changing Role of Banking Supervision

Good afternoon. My remarks today on the occasion of this timely conference will focus on the major developments occurring in the European financial sector. Specifically, I will offer my thoughts on how these developments are affecting the banking structure in Europe. And, perhaps most importantly, I will reflect on the implications of these financial system changes for the supervision of financial institutions.

Trends in the European Financial Sector

The European financial sector has been experiencing several major developments: deregulation, the introduction of the euro, the internationalization of the financial markets, disintermediation, and rapid technological change. I would like to speak on a few of these issues.

I will begin with deregulation. Compared with the regulated European financial systems of the postwar period, most European countries have been liberalizing their financial services sectors. This trend began in the mid-1960s and accelerated in the 1980s and 1990s. At the same time, European countries have progressively opened their financial markets to foreign competition. These actions came about through independent national legislation as well as from the dynamics of the Treaty of Rome, which received a renewed impetus from the single market program. Furthermore, the Second Banking Coordination Directive—implemented on January 1, 1993—introduced the single banking license, which allows credit institutions to establish branches or to supply cross-border services to all European Economic Area countries without prior approval from the authorities of a particular country. The European Union is aiming for a fully liberalized European market for financial services by the year 2005.

On the surface, this open legislative environment looks good, but in practice it has been frustrated by infrastructural impediments, which are still prevalent in some countries. Notably, government ownership has prevented liberalization for a long time, although over the past few years there has clearly been improvement, especially in southern European countries such as Spain and Italy. In Germany, however, the local government's ownership of savings banks and so-called *länderbanken* still stands in the way of a more market-oriented development.

Disintermediation, too, has had an impact on the European financial sector. The introduction of the euro has stimulated the internationalization of the capital markets, thereby making these markets deeper, more transparent, and more liquid than the previously existing national capital markets. It has forced banks to reassess their position in the market. In most institutions, including mine, net income from interest has declined, reflecting the shift from the role of traditional credit intermediary to that of fee-based income generator. It will be

Tom de Swaan is a member of the managing board of ABN AMRO Bank.

interesting to see whether the Capital Accord redesign affects this development.

Another development—technological change—has been present in the European financial sector since the 1960s and 1970s. At that time, banks began to reduce the costs of their information processing capabilities by replacing paper- and labor-intensive operations with computers. However, the impact of computerization is small compared with the impact of network technology. For example, the interlinking of real-time gross settlement systems through the European TARGET system has greatly stimulated the development of a single European money market. But the mark made by network technology will be even more profound because the Internet will alter the ground rules of our economy, as the classic trade-off between richness of information and reach of information will end, and communications costs will decrease and eventually disappear.

U.S. companies, supported by a more flexible labor market, have been able to adapt their organizations and strategies to these technological changes more effectively than European companies. As a result, the U.S. Internet penetration rate currently is 60 percent, compared with the European Union's rate of just 14 percent. In addition, the United States accounted for 67 percent of the total volume of electronic commerce in 1999, compared with 17 percent for the European Union. The characteristics of the new economy—such as high job growth combined with low inflation—are not yet as visible in Europe, where unemployment is still as high as 9 percent, although it is decreasing rapidly.

Nevertheless, the size of the European Union market—which, in terms of number of consumers, is larger than the U.S. market—is creating major opportunities. The European Union will soon close the gap with the United States by further integrating and liberalizing the internal market. The liberalization of the telecommunications sector, for example, should contribute to a greater reduction in telecommunications costs, thereby encouraging the broader public to use the Internet. Moreover, the development of a single legal framework for security, privacy, tax, and intellectual property issues will also help to integrate the internal market.

Changes in the European Banking Structure

How, then, have these developments affected the European banking structure? The introduction of the euro, for example, has stimulated the evolution of an integrated internal European market for financial services, which is lowering entry barriers and forcing European banks to redefine their traditional, national home-market positions. Consequently, mergers, acquisitions, and alliances could and should be taking place, because banks are being compelled to defend their traditional home-market positions while they strengthen their positions in the much larger European market.

Thus far, however, the recent wave of consolidation has taken place mainly within national boundaries, and in some countries it is still in its initial phase. In Germany, this phenomenon is due primarily to state- and local-government-owned retail banks, while in Italy, the privatizations have yet to lead to consolidation. And no doubt you are all aware of the failed attempt to create a national champion in France. In fact, there are only a few small European countries, such as Benelux and the Scandinavian countries, and one large country, Spain, where in-country consolidation has occurred.

Similarly, cross-border consolidation, in my opinion, is still at an early stage. National interests have created a high barrier to this type of consolidation, as local governments have emphasized the development of national champions that can compete on a European and global scale. And let us not forget the major legislative and governance problems involved. Furthermore, one cannot expect that the banking sectors in countries such as France, Germany, or Italy will be as concentrated as the banking sector in a small country like the Netherlands, where the top three banks account for 80 percent of the retail market share. The domestic markets in France, Germany, and Italy are much bigger, and therefore offer room for a greater number of viable banks.

In terms of technological developments, they have already started to have an effect on branch networks, albeit to a varying extent in different European Union countries. A good example is Internet banking, which reduces the need for an extensive brick-and-mortar branch network. In fact, as part of its multichannel distribution strategy, ABN AMRO has decided to reduce the number of branches in the Netherlands, and plans further reductions.

Apart from reducing the size of brick-and-mortar branch networks, it is still not completely clear how the Internet will affect the financial system in Europe. One possible scenario is that vertically integrated institutions will lose their raison d´être, as transaction costs between functional units of the same organization dwindle. As a result, it might be more efficient to outsource certain activities and focus on particular aspects of the previously integrated value chain. Some believe that, through the unbundling of the value chain, specialization will become the dominant business model in banking and financial services because it enables institutions to provide the most value to customers at this mature stage of the industry.

However, there currently is not much evidence that this development will take place. In my opinion, the chance that a virtual bank will ever be in a position to take over the role of a traditional retail bank fully is very small, if not nonexistent. I believe in the concept of retail clients being in a position to choose from several distribution channels to conduct different kinds of transactions with their bank. In this respect, Internet banking is just one of those channels, albeit an important one.

Another possible scenario is that in the Internet era, banks will run the risk of losing their unique position as financial intermediaries. The overabundance of available information certainly creates opportunities for new Internet intermediaries. By developing financial portals, the largest European banks are fighting for this unique position. In this respect, the alliance in Spain between BBVA and Telefónica creates added value for both organizations, because they can combine their client bases while BBVA delivers the content and Telefónica the technology for a financial portal. Similar alliances between telecommunications companies, banks, insurance companies, and supermarket chains will surely emerge in Europe in the near future.

The Internet's role in the European financial system will also have implications for banks that operate as trusted third parties for transactions, or TTPs. TTPs are particularly important for business-to-business e-commerce, in which the monetary value of the transactions, and thus the risk involved, is the largest. Specifically, eight banks—including Chase, Citigroup, and ABN AMRO—initiated Identrus last year, which is designed to become a network of TTPs through the issuance of digital certificates. The goal in three years is to make Identrus the largest TTP network worldwide—with more than 300 connected banks and more than 5,000 connected companies—to enable internationally accepted, standardized, and secure Internet transactions.

Banking Supervision

With these myriad changes taking place in the financial system, how will supervision of the financial services industry adapt? I would like to offer some observations on the organization and structure of supervision, particularly in the European Union.

First, with the start of European monetary unification, oversight of the European Union's monetary policy has been assigned to the European Central Bank. Article 105(5) of the Maastricht Treaty states that the Bank's responsibility with respect to banking supervision is to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system." Operational supervision—both at the micro and macro levels—is thus left to the national bodies of the individual European Union member states.

Second, many countries still have separate regulatory bodies that supervise different types of financial institutions. The Netherlands, for example, distinguishes the central bank—which is responsible for banking supervision—from the insurance board and the securities board. Although the objectives of these national regulators are more or less the same, supervision by the central bank and the insurance board focuses primarily on the stability and soundness of individual institutions, while supervision by the securities board is directed toward consumer protection. Furthermore, these three financial sectors are governed by three different laws, but they are based on the same principles of European Union legislation, such as the "single license" and "home-country control."

My third observation along these lines is that the differences in supervision owing to national differences are worth noting. For instance, the universal banking model—the model of the largest banks in continental European countries such as the Netherlands, Germany, and Switzerland—has created differences in the structure of supervision in these countries vis-à-vis the structure in such Anglo-Saxon countries as the United Kingdom and the United States. In countries with universal banks, supervision also involves regulation of a bank's securities activities, a practice that is necessary to judge an institution's overall stability. For example, in the Netherlands, de Nederlandsche Bank has prudential supervision over all financial institutions that can potentially cause systemic risk, except for insurance companies. So, although the Netherlands has various supervisors for various institutions, regulation of the Dutch financial system is not entirely sector-specific.

I should note that I do not favor a division between banking supervision and monetary policy. In light of the changes under way in the financial services industry, one must consider whether a country-specific and sector-specific supervisory approach can properly safeguard the stability of the financial system. Many of the developments in the financial services industry, some of which I have just mentioned, have had an impact on the effectiveness of current supervisory practices.

Economic integration and the increased interwovenness of the financial markets, for example, have heightened the complexity of the financial system. Consequently, bank vulnerability to developments affecting other market participants in other countries and in other financial sectors has also been heightened. Because of the interrelationship between market participants and markets, a break in the transaction chain at one market participant may have a domino effect worldwide. Unfortunately, the financial turmoil in Asia and its aftermath in Russia and Brazil provided evidence of such an occurrence, as did the subsequent reactions in the western capital markets, where the rush for cash led to a sharp deterioration of liquidity as well as to the downfall of the Long-Term Capital Management hedge fund. The Asian crisis in particular has shown that, in tandem with the globalization of the financial system, systemic risk is also globalizing.

Other developments affecting supervisory practices are the emergence of Internet banks and financial conglomeration. Internet banks are not, in practice, bound by national borders. Moreover, these institutions, which are also not subject to European Union banking legislation, will be able to provide services and sell products throughout the Union. The lack of national borders will complicate the supervision of Internet banks, raising the question of whether a national regulatory authority can conduct bank supervision to protect consumers.

Financial conglomerates are regulated by a multitude of home-country supervisors. However, these sector-specific authorities in many cases have an insufficient grip on the capital position and activities of the holding companies. For example, "double leverage" could lead to a distorted view of the financial position of the companies' bank and insurance businesses, as the same capital is being counted twice. Conglomeration could also provoke moral hazard behavior in the form of supervisory arbitrage, as institutions move certain activities to parts of the organization that are subject to less rigorous supervision.

As the globalization and complexity of the financial system increase, cross-border and cross-sectoral cooperation among supervisory authorities, as well as greater harmonization and standardization of regulatory rules, will be essential. Accordingly, various sector-specific international groups of supervisory and regulatory agencies—such as the Basel Committee on Banking Supervision, the Joint Forum on Financial Conglomerates, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions—will play a leading role going forward.

I should note that an attempt to enable pan-European supervision is provided for in Article 105(6) of the Maastricht Treaty, which could give the European Central Bank specific supervisory responsibilities. However, although the provision would end the functional and geographic separation between monetary policy and prudential supervision, it would not end the sectoral split in financial services supervision. This is because effective lobbying by the insurance industry on the eve of the treaty's signing has led to the exclusion of insurance supervisors from the provision. In addition, the provision is only a "last-resort" clause, based on the unanimity of the European Union member states.

Importantly, I have doubts as to whether the initiatives for cross-border and cross-sectoral cooperation, of which I mentioned only a few, can go far enough and fast enough in light of the globalization of the financial system. For example, cooperation between independent supervisory bodies could result in conflicts of interest as well as overlaps or gaps in supervisory practices. Moreover, differences between national supervisors in terms of resources, culture, and legal interpretations could place serious roadblocks on the path to international harmonization or centralization of supervision. And any overlap in supervisory activities will lead to increased costs.

Of course, it is reasonable to ask whether further integration and centralization of supervision across national borders and financial sectors is desirable. The activities and risks involved in each financial sector are very different and require different types of supervision. Also, the specialization trend associated with the evolution of the Internet—in contrast with the developments associated with globalization and conglomeration—will call for product-specific regulation. Clearly, given the market developments under way, the role of the European Central Bank, the European community, and the national authorities will require further consideration. In this respect, I very much welcome the initiative of the so-called "Eurogroup," chaired by former economics minister of France Alphandéry, to begin a wide-ranging reassessment of the supervisory infrastructure in Europe.

Nevertheless, in my view, pan-European centralization of supervision in line with the British model of the Financial Services Authority is not a solution. The imbalance between the structure of supervision and the structure of the financial sector would still exist if the current supervisory bodies were combined into one organization. The new organization would be a giant, conducting bureaucratic and unfocused practices that would prove to be slow and ineffective in reducing systemic risks. Moreover, the damaging effect of negative publicity would be much larger in the case of a single pan-European supervisor, as it would undermine the status of this authority and affect the entire European financial services industry.

It is also reasonable to ask whether supervision, be it nationally or supranationally organized, can reduce systemic risk effectively. More and more financial firms that are not subject to supervision can cause systemic risk. Examples range from hedge funds such as the aforementioned Long-Term

Capital Management to giants such as GE Capital. Supervisory authorities are trying to come to grips with these different types of entities by overseeing the institutions that supply them with credit, which is sometimes like killing the messenger.

Having said that, the question remains as to how to structure and organize the supervision of financial services. Given the political sensitivities, the chances for major cross-border changes in the near future are rather small. Improvements, for the time being, will have to come from increased cooperation among national supervisory bodies. In a number of cases, this will probably lead to more United Kingdom–like supervisory bodies—as I observed, a development that I do not necessarily favor. The sketchy information that I have received from London at the very least suggests a slow and sticky process of integrating the three supervisory bodies.

Nevertheless, let us assume that political objections can be overcome and that we are asked to redesign a supervisory system for Europe. As such, perhaps it would be interesting to look at a modified Australian model. This model divides supervisory responsibilities between supervisory authorities according to their various objectives. Such a division would result in three authorities: one for financial stability, one for consumer protection, and one for market integrity.

The supervisor responsible for financial stability would oversee all financial institutions that could potentially cause risk. It would conduct macro prudential supervision as well as be responsible for, or at least involved in, monetary policy. The authority could and probably should be organized on a European level. The supervisory agency responsible for consumer protection would regulate the remaining financial institutions and manage a minimal deposit insurance plan. It would also oversee the rules of conduct for personal integrity, organizational integrity, and relationship integrity—focusing on the relationship between financial institutions and consumers, particularly with regard to the delivery of information. This agency, at least for now, could be organized on a local level. Finally, the supervisor responsible for market integrity would oversee market transparency and market discipline.

Could such a supervisory system function in Europe? I honestly do not know. Or, should I say, deep in my heart I know that it is a utopian way of thinking. But a fresh look at a situation that is becoming increasingly complicated is always useful. I could more realistically imagine a separation between regulatory and supervisory authorities in which a pan-European regulatory body is established, while day-to-day supervision becomes a local responsibility and therefore is performed by national bodies.

Finally, a pet issue of mine is to see the financial market functioning as a supervisory system, a scenario that should be promoted much more vigorously. Financial products and markets are growing so complex that it is becoming more and more difficult to include all of the possible risks in fixed rules, and hence it is becoming more and more difficult for supervisors to monitor these risks effectively. With the necessary information, the financial markets could have a disciplinary effect on the financial industry and could serve as the most efficient and effective supervisory system. Market transparency is the ultimate condition for market discipline because it requires disclosure by banks of the information relating to their capital structure, their risks, and the adequacy of their capital position as a means to control those risks. This issue is exactly what is addressed in the new capital adequacy framework proposed by the Basel Committee. Such transparency and disclosure, by the way, should also apply to supervisors.

I would like to conclude by reminding you of the redesign of the 1988 Capital Accord. I know that it does not pertain to an infrastructural redesign of the supervisory system, and it should not. But let us not forget that the original Accord led to a fundamental rethinking of banking supervision in the 1980s and 1990s. I am convinced that the new Accord will help set the stage for a rethinking of financial supervision in the early part of the new century.