SUOMEN PANKKI FINLANDS BANK
EUROJÄRJESTELMÄ
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Deputy Governor Pentti Hakkarainen, Bank of Finland

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Comments on "Financial sector integration – its role as a facilitator of the catching up process".
Text is not identical with the comments presented at the panel, should be deemed as a background non-paper.

- First, it is clear that financial sector integration plays an important role in the catching-up process of the Baltic states.
- Financial integration has brought about significant benefits.
- Entry of foreign banks has brought both improved risk management techniques as well as increased access to funding from parent banks.
- Without this activity of foreign banks, lending growth and hence the catching-up process would have been slower, as such growth could not have been financed domestically as the cost of capital would have been higher for smaller local banks.
- Integration has created a more competitive banking sector environment (with declining interest rates), improvements in the institutional environment, and increased creditworthiness of borrowers on the back of improved economic prospects.
- Banking sector reform also represents a key development in the transition countries. Banking sector reform has led to the emergence of new market segments and increased the range of products available to bank customers, and at the same time reduced costs.
- More efficient allocation of capital, reduced cost of borrowing as well as increased availability of funding contribute positively to economic development via lowering investment costs and accelerating productivity growth.
- Deep and liquid financial markets also strengthen the resilience of the European economy by sharing risks between regions through diversification of ownership.

- Hence, it can be argued that financial integration is overwhelmingly positive for the catching-up process of CEE countries.
- However, extensive foreign ownership in the banking sector makes financial sector stability and hence entire economic stability dependent on the continued commitment and stability of the foreign banks.
    - In the three Baltic countries, the market share of the 3 largest foreign-owned banks (mostly subsidiaries but also branches) is 75% in LIT, 55% in LAT, and 86% in EST; and foreign ownership in general is very high and close to 100% .
    - In Finland, we are facing a similar situation with two major foreign owned banks controlling over 50% of the loan and deposit markets.
- Hence, there is a strong need to have a regulatory / supervisory framework in the EU that is compatible with the integrated markets.
    - The framework should be efficient and have well-coordinated supervision by the home authority and it should respect the legitimate concerns of the host authorities to be involved in the supervisory process of the major cross-border banks.
    - Smooth cooperation amongst supervisors is needed to allow concerns regarding local economic developments to be taken into account in the supervision of the cross-border banking groups (e.g. concerns of too high credit growth or too lax lending standards).
- Banking supervision in the EU has been based since 1989 on the principle of home country control. Based on this principle, the supervisor in the EU country that has given authorisation to a bank supervises the entire banking group including any branches operating abroad.

- As a consequence of the integration and internationalisation of financial markets, the responsibilities and competences of authorities in different countries are no longer entirely aligned. This is the case particularly for systemically significant branches of cross-border banks.
- In terms of risks to the entire banking group and to the host financial sector, it is of secondary importance whether the bank has organised its operations through subsidiaries or branches, but in terms of legal responsibilities, there is a stark difference in the EU framework.
    - This distinction should be milder to allow more cost-effective coordination in case of subsidiaries (reduce the overlap of many national supervisions) and to allow adequate host country involvement in case of significant branches.
- Bank of Finland has proposed four enhancements to the current EU financial stability framework which would go to this direction. At the moment, these issues are being evaluated as changes to the Capital Requirements Directive to be concluded on this year. This action by the Commission is very welcome, in particular as it considers establishing a legal role for supervisory colleges and clarifying the role of host supervisors of systemic branches.
- These enhancements are:
    - A mandatory requirement for the exchange of information between the home and host country supervisors in case of systemically important branches.
        - This seems to be one of the objectives of the current Directive reform. The information exchange framework set out in MoUs should be strengthened by legal, compelling rules for information exchange both in normal and crisis times.
    - A mandatory requirement for the delegation of ongoing supervisory tasks to host supervisors of systemically important branches.
        - There does not seem to be appetite at the moment to make delegation nothing but voluntary. Supervisors seem to agree that specific supervisory duties should be carried out by those that are best placed for conducting them. But there are seem to be legal obstacles at the national level and supervisors are vary of delegating duties on which they can be held liable at a later stage should problems emerge. Hence, strong obligations seem to be needed in EU legislation in order to safeguard the interests of host countries and increase the cost-efficiency of supervision (and optimise the use of expertise of home and host authorities).
        - Also the delegation of responsibilities should be considered, not only the delegation of tasks.
    - A mandatory requirement for the establishment of supervisory colleges and involvement of host country authorities in case of systemically important branches.
        - The composition of the college should not be the unilateral decision of home supervisors, but also involve the host supervisors in a joint decision. (When there is no agreement, mediation mechanism at the Level 3 Committee could be used).
        - The legally-defined duties of the college should involve ongoing supervision as well as crisis management. Some recent suggestions have dealt with improving only crisis management procedures. However, it will be impossible to manage crises effectively if cooperation is activated only when a crisis is already in hand. The EU legislation is also most underdeveloped where ongoing cooperation between supervisors is concerned.

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- Involvement of host country authorities in crisis management and resolution of cross-border banks with systemically important branches.
  - This should involve an obligation that home supervisor consult the college (including host branch supervisors) on major supervisory decisions concerning the banking group.

– These four enhancements in the EU financial stability framework would be necessary to facilitate effective ongoing supervision. They would improve the possibilities of maintaining stability at the national level and lead to more coordinated and efficient crisis management solutions at the EU level. They could also remove obstacles to further integration and branching by cross-border banks, by alleviating the concerns of predominantly host countries.

– To conclude, I would like to emphasise that these issues are relevant for the whole EU, not just for the Baltic states or in the CEEC.
– The integration process continues and an increasing number of large and complex banking groups will be created.
– Therefore, we must have a well-functioning EU level framework in place to manage potential problem / crisis situations.
– As we learned from the Northern Rock case in the UK, a crisis situation can take place very suddenly even in an environment with well-developed institutions.